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This basic money book takes a creative approach for visual learners by using icons, varied fonts, and highlighted text. The book's design will appeal to holistic thinkers by allowing them to jump from point to point without losing overall meaning. It is divided into five sections, each with a subset of related topics: (1) "The Big Picture" looks at financial goals, attitudes, financial inventory, and some basic money rules; (2) "How Money Disappears" discusses consumer debt, inflation, and personal income taxes; (3) "How Money Grows" explains the workings of savings accounts, investments, and home ownership; (4) "Protection" delves into the ins and outs of seemingly every type of insurance policy available; and (5) "Planning and Priorities" provides tips and details on establishing financial priorities, a planning structure, estate planning, and long-range funding goals. A concluding appendix contains information about the Federal Reserve System, tax brackets, community property states, social security benefits, and the definition of disabilities. Includes endnotes and a glossary. (DQE)

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A Money Guide for the Creatively Inclined

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PAULA ANN MONROE

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LEFT-BRAIN FINANCE FOR RIGHT-BRAIN PEOPLE

A Money Guide for the Creatively Inclined

Paula Ann Monroe

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Naperville, Illinois

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DEDICATION

To two special people in my life:

My intelligent, sensitive husband, **JOHN FARRELL FAY**, an accomplished trial attorney and author of his own book on the law, who completed his education in excellent institutions with a business major, but was never taught the important principles found in this book. Sweetheart, you have mastered well the first thing you can do with a dollar: spend it. My hope is that you will now master the other two things you can do with that same dollar: save and invest it.

and

To my sister **LOUISE WILLOUGHBY**, a wonderful first grade teacher, who inspired the idea behind this book when she put down my original manuscript and announced, "I don't read anything that doesn't have pictures!"

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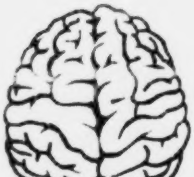
SANDY, my deceased Golden Retriever, who was my constant companion and lay at my feet as I worked on this text.

INTRODUCTION

LEFT-BRAIN FINANCE FOR RIGHT-BRAIN PEOPLE is a basic money book with an innovative approach. It is specifically written for creative adults who find the standard books about personal finance boring. Typically, such readers become overwhelmed reading page after page of print with no visual references.

RIGHT-BRAINED PEOPLE THINK DIFFERENTLY, AND THIS BOOK COMPLEMENTS THEIR STYLE. IT DOES NOT HAVE TO BE READ FROM BEGINNING TO END TO MAKE SENSE; MANY DIFFERENT SEQUENCES WILL WORK. KEY PHRASES SUMMARIZING THE MAIN POINTS, AND OVERVIEWS INTRODUCING EACH PART MAKE IT EASY FOR THE READER TO SKIP AROUND OR REVIEW PARTICULAR TOPICS OF INTEREST. IN ADDITION, THE GRAPHS, TABLES, PICTURES, ANECDOTES, AND STORIES AID COMPREHENSION FOR THOSE WHO LEARN BEST BY USING THESE MEANS.

THE LEFT-BRAIN vs. THE RIGHT-BRAIN



Our bodies are bilateral and the brain is no exception. It has two identical hemispheres joined by nerve fibers. Just as people are left- or right-handed, they are also left- or right-brained. "Left-brained" people have dominant left hemispheres, while "right-brained" people have dominant right hemispheres. We don't know why some people develop the right side of their brain more than the left or vice-versa. The development could be hereditary, or it could be preference. The fact remains, however, that for most people one side is dominant.

Our brain has two sides: left and right.
EVERY PERSON HAS A DOMINANT SIDE

INTRODUCTION

THE LEFT SIDE:
- **Logical**
- **Reasoning**
- **Literal**
- **Thinks part to whole**

Each hemisphere excels at different skills, with the dominant hemisphere influencing a person's general thinking patterns. The left side is logical; the right side is holistic. The left side comprehends through reasoning; the right side comprehends through images. While the left side listens to the literal meanings of words, the right side listens to tone of voice, body language, and voice inflection. The left side works with the smaller parts leading to the whole, but the right side previews the whole first, then works with the parts. Left-brained thinkers can put a jigsaw puzzle together by studying the individual pieces. But, the right-brained thinker wants to see the picture on the box cover before the pieces make sense.

THE RIGHT SIDE:
- **Holistic**
- **Imaginative**
- **Figurative**
- **Thinks whole to part**

Left-brained thinkers approach the world in a linear fashion. Compare them to a straight line. Their minds naturally move in sequence from point "A" to point "B" then to point "C." They remember details easily, follow directions without difficulty, and often have good vocabularies. After reading several pages, they can accurately summarize the main points. Describing and labeling are effortless because their minds move naturally from **PART** to **WHOLE.**

In contrast, right-brained people rarely start at the beginning and move in sequence from "A" to "B." Instead, they jump around from point to point: "M" to "C" to "A." Compare them to a curved line. Visualization, intuition, and artistic expression are their strong points. They associate ideas with pictures, colors, and textures. Frequently, right-brained people do not remember a stranger's name, but they do remember his general appearance and if they liked him. Right-brain thinkers start with the **WHOLE** then move to the **PARTS**. Only when their trial and error methods fail do they resort to reading directions.

Some people naturally work better with numbers and formulas, while others work better with people and ideas. Most likely, if this book caught your eye, you are the latter. You are a "do-it-yourself" personality, directed by your visions. You probably excel at counseling, composing, teaching, creating, or building, not at following budgets, figuring taxes, balancing checkbooks, or calculating gains and losses.

INTRODUCTION

This book is written for people who tend to be more right-than left-brained. It starts with the basics and builds a foundation that will help creative thinkers better understand themselves and how they use their money. This book does not assume its readers know how to figure net worth, or know the difference between income and growth investments. Moreover, it is the first practical guide on personal finance written especially for those who find the "money world" complex and boring.

RIGHT-BRAINED ADULTS NEED A MONEY BOOK THAT HAS

- **Graphs**
- **Pictures**
- **Stories**
- **Summaries**
- **Overviews**

This book has five sections:

1. The Big Picture
2. How Money Disappears
3. How Money Grows
4. Protection
5. Planning and Priorities

The chapters in each section give more information about the section topic. Following the introduction to each section, you will find a mindmap that outlines the material presented in the chapters. Mindmaps are graphic outlines and serve as a quick, easy way to find needed information.

An overall mindmap of the book, plus another copy of the section mind maps are located after the standard Table of Contents. Since a mindmap is a visual reference tool, your right-brain may prefer it to the Table of Contents. Both are included to give you a choice.

This book is designed so you can easily find information and skip around to read the parts that interest you. Few right-brained people would attempt to read a book on finance. This book is different because you can glance through it and learn from the highlighted text, the pictures, and the charts. Then when you want to learn more, just read the text. **KEY SENTENCES AND IDEAS HAVE BEEN SET OFF IN A DIFFERENT FONT. BY GLANCING AT THE KEY IDEAS AND BY GLANCING AT THE TEXT BOXES, YOU WILL LEARN THE MAIN POINTS AND KNOW WHERE TO FIND NEEDED INFORMATION.** Most people are not interested in a financial topic until it affects them. Use this book to read about information when it is meaningful to you

Most people are not interested in a financial topic until it affects them

THIS IS A TEXT BOX

INTRODUCTION

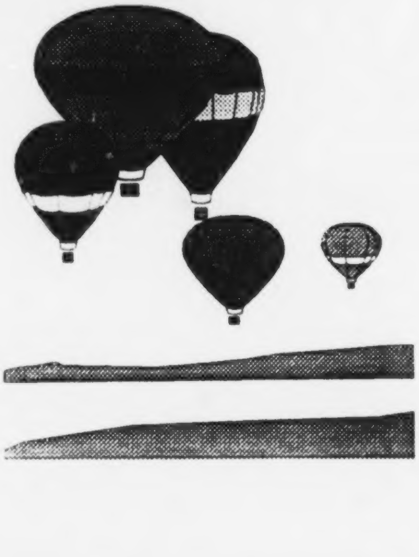
By using this text as a reference, you can stay on top of your finances. It won't turn you into a financial whiz (unless you already are one), but it will give you a working foundation of knowledge. This foundation will aid your continued learning because you will recognize where previously ignored "pieces" fit into the total financial puzzle.

PART I

The Big Picture

The big picture comes from an objective view of your finances. It includes looking at your money goals, your prosperity attitude, and your spending and saving habits. Part I covers:

- FINANCIAL GOALS
- ATTITUDE
- TAKING FINANCIAL INVENTORY
- BASIC MONEY RULES



If you take a ride in a hot air balloon, the higher you rise, the smaller the landscape becomes. As you journey upwards, the horizon expands to show more of the surrounding area and to give you a broader view. While reading the chapters in Part I, maintain a similar perspective applied to your finances.

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Chapter 1

Financial Goals

LOOK AT THE BIG PICTURE

TAKE A MOMENT TO LOOK AT THE BIG PICTURE OF YOUR LIFE: WHERE YOU ARE NOW, WHERE YOU'VE BEEN, AND WHERE YOU WANT TO GO. To accomplish what you want with your money, you need to: 1) have some financial goals, and 2) know what you can realistically achieve. See the road you are traveling, away from the bustling of daily living. Try to step back and get an objective view. With the big picture in mind, look at:

❶ Where you are in the LIFE CYCLE
❷ The LIFESTYLE you want to live
❸ Your VALUES and AMBITIONS

Heading For
The Future

Lifestyies and Life Cycles

During the fifties, first grade children learned to read from a "Dick and Jane primer" that featured a family living in a large, white house on a quiet, tree-lined street. Dad wore a suit to work and carried a briefcase, while Mom stayed home to care for the house and family. Spot, the family dog, would faithfully wait every afternoon at the picket fence for Dick and Jane to come home from school. On Saturdays, Dad would mow the lawn or wash the family car. Spot romped around the spacious, well-groomed yard playing with Dick and Jane.

The Dick and Jane books tried to portray the typical American lifestyle for that time period. In reality, however, many children thought they were atypical, to the point of being "abnormal," because their circumstances were so different. Perhaps these children had a single parent, or lived in an apartment building with no lawn, or lived on a farm. Maybe, their dad was a fisherman, or their mom worked, or they had a cat, a hamster, or a snake for a pet.

Lifestyles are as diverse as the people who live them

In the nineties, we do a better job recognizing and accepting different lifestyles. We are exposed to many workable role models. After all, lifestyles are as diverse as the people who live them. Some people are single, others are married, still others have a live-in partner or are part of an extended family. All options could involve raising children.

GIVE SERIOUS THOUGHT TO THE LIFESTYLE YOU WANT TO LIVE. Consider your options so you make a conscious decision about how you live your life. **YOUR LIFESTYLE DECISION WILL AFFECT HOW YOU USE YOUR MONEY AND YOUR TIME.** The "Dick and Jane" model may work for some, but not for others. Supporting another person and/or raising children has a monetary cost. It also includes many emotional rewards. Think things through so you know what you want. **BLIND DECISIONS THAT AFFECT YOUR LIFE ARE DIFFICULT TO CHANGE.**

Lifestyle influences spending priorities and financial goals

Your lifestyle influences your spending priorities and your financial goals. It tells how you earn a living, where you live, and who lives with you.

- ➜ Are you single or with a partner?
- ➜ If you have a partner, does he or she contribute financially?
- ➜ How much do you earn? Will this sum increase over time? How much?
- ➜ What are your job skills?
- ➜ What are your other talents?
- ➜ What obligations take your income away?
- ➜ Do you have ongoing family commitments, such as college tuition, child support, or alimony?
- ➜ What are your spending habits?

Whereas a **LIFESTYLE REVEALS CIRCUMSTANCES AND LIVING CONDITIONS**, where you are in the **LIFE CYCLE REVEALS A TIME**, such as:

➜ SCHOOL AND TRAINING YEARS — ages 6 to 24
➜ WORKING YEARS — ages 25 to 65
➜ RETIREMENT — ages 65 to 85

LIFE CYCLES ARE ALSO FLEXIBLE. The number of years spent in school depends upon career choices. During the "working years," some people may go back to school for more training or for the required education to start a new career. Others never finish school or become well seasoned in any occupation. Some people retire early, some continue working as long as their health allows, and some choose semi-retirement.

EXTRA TIME AND ENERGY SPENT IN ONE PART OF THE LIFE CYCLE WILL OFTEN PAY OFF IN ANOTHER. For example, higher education and more training usually translates into higher income during the working years. Productive working years enhance retirement. Most people go through all three cycles, so look at where you are now and what you can do to make your next cycle better.

Values and Ambitions

You make decisions based on what you value

You make decisions based on what you value. Financial goals cannot be separated from these values. **TAKE THE TIME TO KNOW WHAT YOU VALUE AND WHAT YOU WANT TO ACCOMPLISH.** Look at:

- ✔ What is important to you
- ✔ What makes you happy
- ✔ What you want to experience during your lifetime
- ✔ What lifestyle you want to live
- ✔ What skills you want to develop
- ✔ How much money you want to have
- ✔ How you want to spend your money
- ✔ What you want to contribute to others

ANSWERS TO THE ABOVE QUESTIONS REVEAL YOUR VALUES AND YOUR AMBITIONS. Both give your life direction and purpose. Without a destination, any road will do. While traveling on "any" road, an obstacle can easily stop your progress. When you know your destination, however, you travel on a specific route instead of "any" road. **WITH DIRECTION AND PURPOSE, OBSTACLES MAY SLOW YOU DOWN, BUT WON'T STOP YOU FROM MOVING FORWARD.**

Without a destination, any road will do

Focused direction has power

Focused direction has power. Many streams meandering through the woods have little force, but once joined upon a single course, they become the mighty rivers providing the energy that runs cities.

DEFINE YOUR VALUES SO YOU KNOW WHAT IS IMPORTANT TO YOU, THEN DEFINE YOUR AMBITIONS SO YOU KNOW WHAT YOU WANT TO ACCOMPLISH. List both on paper until they become clear and specific. Clear values and clear ambitions are necessary to formulate your financial dreams.

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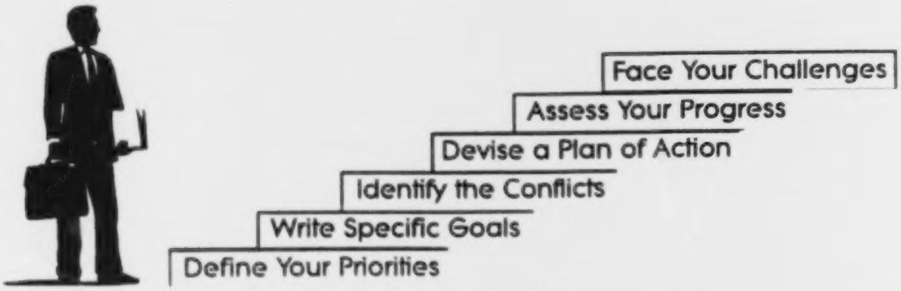
FINANCIAL GOALS



Define Your Priorities

Start now to plan for all your tomorrows

THE FOUNDATION FOR FINANCIAL SUCCESS IS MONEY AT WORK. Many people, however, never find the "right" time to put some dollars away. In their twenties, these people feel ample time exists later to begin saving, so spending money on recreation receives the higher priority. Then, in their thirties and forties, they find funds tight because they are buying a home, or raising and educating children. So, they enter their fifties to discover *time* only has a few years to work until they retire. Unfortunately, for many, it takes too much money at this late date to build an adequate nest egg. As a result, maintaining a comfortable lifestyle in retirement is difficult. In this predicament, they regret that they didn't find a way to start saving and investing when they were younger. Don't let this happen to you! **THINK ABOUT YOUR FUTURE PROSPERITY, AND START NOW TO PLAN FOR ALL YOUR TOMORROWS.**

Those who don't set financial priorities have trouble accumulating assets

Those who don't set financial priorities probably won't increase their net worth. Their expenses grow with their income. After paying the bills, they seldom have money left to put to work for them. **MANY PEOPLE REACH MIDDLE AGE WITH EMPTY BANK ACCOUNTS AND UNFULFILLED DREAMS BECAUSE THEY HAVEN'T GIVEN WHAT THEY REALLY WANTED A PRIORITY.** While time passed, they didn't focus on their goals. At this late date, they launch new careers, begin to exercise, and because retirement is near, finally start to save. Now they need to make drastic changes to make up for losing so much time.

KNOW WHAT YOU WANT TO ATTAIN WITH YOUR MONEY. IF YOU DO NOT TAKE CHARGE OF HOW YOU SPEND YOUR MONEY, YOU ALLOW CIRCUMSTANCES TO DIRECT YOUR SPENDING. WHEN YOU DON'T GIVE MONEY AN OBJECTIVE, IT WILL GET USED UP ON WHATEVER COMES ALONG.

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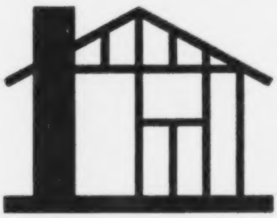

Planning your finances is similar to building a house. The design comes first, then selection of the proper materials. A single board contributes a small, but important part to the structure of the house. It takes many boards nailed together to build a frame. **WITH FINANCIAL GOALS, CONSISTENCY AND TIME ARE IMPORTANT "BUILDING MATERIALS."** Money put aside from one paycheck contributes a small part. It takes many weeks, or even years, of consistent saving to reach a financial goal.

A blueprint directs the building of a house. It shows how to construct a strong foundation, what materials to use, and when and where to place them so they will fit. Without a blueprint, building is haphazard, hit-and-miss. **SIMILARLY, FINANCIAL GOALS DIRECT HOW YOU SPEND YOUR MONEY.** They help you establish a strong financial base. From this base you then have many options available to meet different financial objectives. A good plan sets up spending priorities that will help you achieve your goals. **A VISION OF TOMORROW GIVES TODAY DIRECTION.**

You will never regret increasing your net worth by saving and investing

Whatever your ambitions, you will never regret increasing your net worth through saving and investing. **THE MORE ASSETS YOU ACCUMULATE, THE MORE YOU INCREASE YOUR OPTIONS, YOUR CONFIDENCE, AND YOUR SECURITY.** The earlier you start thinking about financial goals, the more time you have on your side. With more time, your accomplishments can be greater. *Time* also compensates for not having much "extra money."

Be Specific

Lack of progress is often due to vague goals. You need to get specific about what you want. Some good ways to do this are 1) through writing, 2) through using pictures, or 3) through talking to another person.

Lack of progress is often due to vague goals

The best way to make your ambitions specific is to write them. **UNDEFINED THOUGHTS REQUIRE NO COMMITMENT. CLEAR, SPECIFIC DETAILS ABOUT WHAT YOU WANT LEAD TO COMMITTED ACTION.** In clarifying your goals through writing you may uncover subconscious doubts or forgotten encouragements. **WRITING HELPS YOU BE MORE OBJECTIVE, ALLOWING YOU TO THINK ABOUT MERITS OR PROBLEMS ASIDE FROM YOUR EMOTIONS.** Writing also helps you look beyond other people's biases. Being specific in

Express your goals in writing

writing helps you make new discoveries. Maybe what you thought you wanted, you realize you don't; or, you may find you want to develop a completely new interest.

Express your goals with pictures

If you don't like to write, you can get specific by using pictures. **EITHER DRAW YOUR GOAL OR FIND PICTURES IN MAGAZINES THAT EXPRESS WHAT YOU WANT.** Come up with one picture for each goal. You might want to use to use these pictures to make a scrapbook or collage. Take time in drawing or selecting your pictures. Make sure the details fit your goal exactly. If they do not, you may be sorry. Being specific is a powerful tool; you could end up with what is in the picture instead of your goal if they are not the same.

Tell your goals to another person

Expressing your thoughts to someone close to you is the least effective way to become specific. The person may judge your ideas or put a damper on them before you get the chance to define them clearly. Additionally, by merely expressing your thoughts you have no visual reference.

REFINE YOUR GOALS AT LEAST THREE TIMES, EACH TIME BECOMING MORE SPECIFIC. THE ANSWERS TO 'HOW' QUESTIONS LEAD THE WAY. Forget "why" questions. You do not need to justify your goals to anyone. **CONCENTRATE ON HOW AND WHAT.** If you do not readily know an answer, ponder the question for a few days with "how" directing your thoughts.

1. STATE YOUR GOALS

Example: I want to be wealthy.

Comment: Be more specific—consider what wealth means to you.

Does wealth mean: A large bank account? Many investments? Having your own company? A larger home? A better car? More exotic travel?

2. WRITE SEVERAL SENTENCES THAT BETTER DEFINE YOUR GOALS

Example:

- I would like to retire early and not have to worry about money.
- I'd like to start my own company by the time I'm thirty years old.
- I would like to live in a large house.

Comment: Be more specific. What age would you like to retire?
How much money would you need? What kind of company would you run?
Would anyone work for you? Who are your customers? What do you sell or service? How large of a home? What does it look like? Where is it located?

3. MAKE YOUR STATEMENTS EVEN MORE SPECIFIC

Examples:

- I own a four bedroom home.
- It is on one level and has a spacious backyard with a swimming pool.
- It has a large, sunny kitchen.
- It is located in a hillside subdivision twenty miles from the city.

Name all of the features that are important to you.

- I have investments and savings worth $825,000 at age 65.
- I accomplished this by saving $100 a week for the past 25 years.
- I invest my money in various mutual funds that have an average 12% compound rate of return.

TAKE THE TIME TO COME UP WITH CLEAR STATEMENTS OF WHAT YOU WANT TO ACHIEVE WITH YOUR MONEY. Once you have a specific statement, you will be able to find the information you need to turn these desires into reality. Chapter 4, *Basic Money Rules*; Chapter 9, *Investments*; Chapter 15, *Priorities*; and Chapter 16, *Planning*, will help you identify how much you must save and the best place to save it. **CLEARLY DEFINED GOALS HELP YOU TO STOP THINKING ABOUT WHAT YOU WISH YOU HAD, AND SHOW YOU WHAT NEEDS TO BE DONE TO GET WHAT YOU WANT.**

Focused energy gets results

Identify the Conflicts

IDENTIFY THE CONFLICTS BETWEEN IMPORTANT GOALS. For instance, maybe you do not have enough money to save for a down payment on a home and also to take a European vacation. Perhaps you want to start a new career and also spend more time with your family, but learning the new career will take you away from home even more. When conflicts exist, it is often necessary to select the highest priority and be willing to put the second or third priority "on hold."

PRIORITIZING IS NEVER EASY, BUT NECESSARY FOR MAKING WISE DECISIONS. Greater accomplishments often require giving up something or making concessions. Such negotiations are easier when you know that what you give up is only temporarily surrendered and will eventually take a higher priority position.

Greater accomplishments often require giving up something

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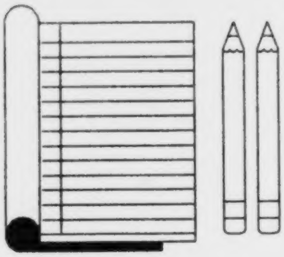
Devise a Plan of Action



EACH SPECIFIC GOAL NEEDS A PLAN OF ACTION. YOU NEED TO WORK OUT, STEP BY STEP, WHAT IT WILL TAKE TO REACH THAT GOAL. Your financial goals require specific knowledge about many money rules, e.g., how much you must save, and for how long you must save to reach a certain sum. You need to know the best places to put your money. Also, it is important to evaluate the risks, rewards, and earnings of different investments. You need to know about tax planning, estate planning, and insurance because they all help to preserve your assets.

This book addresses all of these topics and more to arm you with the knowledge you need to devise a plan of action. **THE FIRST STEP, KNOWING WHAT YOU WANT AND DEFINING IT IN DETAIL IS MORE DIFFICULT THAN WORKING THROUGH HOW TO ATTAIN IT.** Many say they can't or don't know how, but have never resolved the real issue of what they want.

Assess Your Progress

REASSESS YOUR GOALS OFTEN. Through this assessment, weed out what is unimportant, then reconfirm what is important. Continually prioritize the important, and concentrate on your top priorities.

Try to learn from what didn't work out as planned. Above all, don't forget to compliment yourself on your progress. Concentrate on your accomplishments both great and small. **LOOK AT WHAT WENT RIGHT, AND USE IT AS A SPRINGBOARD TO ADVANCE. BUILD ON YOUR SUCCESSES.**

Face Your Challenges

Some people don't take action because they fear failure. Others fear success. Many fear losing face with friends and family. A few choose to be in the background so others will make their decisions. They prefer comfort to challenge.

MOST PEOPLE FACE CRITICISM, DISCOURAGEMENT, AND SETBACKS BEFORE THEY EXPERIENCE SUCCESS. THESE FEELINGS ARE NOT FAILURES, BUT TESTS OF DETERMINATION. Ask any person who has attained a goal that took several years if they were criticized or got discouraged. Overwhelmingly, their answer will be "yes."

SUCCESSFUL PEOPLE FIND WAYS TO WORK THROUGH OBSTACLES. They step back, reassess the situation, and continue forward with a new approach. **THEY KNOW THAT DISAPPOINTMENTS ARE ONLY DETOURS SLOWING THEIR PROGRESS, NOT BARRIERS BLOCKING THEM FROM THEIR DESTINATION.**

Greater challenges invite greater obstacles

All achievements have their challenges and you must have the stamina to face them. **THE GREATER THE CHALLENGE, THE GREATER THE ACCOMPANYING OBSTACLES.** The wind can bend a fragile tree, but a tree firmly rooted becomes stronger after surviving the winds resistance. Give current stumbling blocks a proper perspective by centering on your objective. **TODAY'S INCONVENIENCES SUCH AS STUDYING, EXERCISING, AND DOING WITHOUT TO SAVE MONEY ALL HELP TO CREATE TOMORROW'S SUCCESS.**

Attaining a goal takes commitment and a belief in what you are doing. **IF YOU ARE MAKING PROGRESS, YOU WILL FACE ADVERSITY.** Adversity, however, contains seeds of hope. Focus on the sunlight that will help these seeds to surface. They are your new beginnings.

All adversity contains seeds of hope

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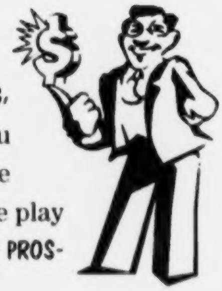
Chapter 2

Attitude

SELF-WORTH AND NET WORTH



YOUR PROSPERITY ATTITUDE IS A PART OF 'THE BIG PICTURE.' TO BUILD A LARGE NEST EGG, A POSITIVE SELF-IMAGE IS AS IMPORTANT AS FINANCIAL GOALS. The amount of money you feel necessary to your lifestyle influences the sum you will receive. Self-made wealthy men and women would readily confirm that self-concept and attitude play an important part in financial success. **THE MIND NEEDS TO ACCEPT HIGHER LEVELS OF PROSPERITY BEFORE IT CAN IMPLEMENT THEM.**

Expectations

Some people live under more promising circumstances than others. Some have more talents or better training. Favorable conditions, however, only play a part in determining financial success. An often overlooked factor is our expectations. **EXPECTATIONS CAN HOLD US BACK OR MOVE US TO GREATER HEIGHTS.** Notice how Hazel, Samuel, and Jonathan all fulfilled their expectations.

HAZEL ARSDALE

Hazel Arsdale, age sixty, dreamed for seven years of going on a cruise. Hazel lived on social security and had little extra money, but decided to save for her vacation. So, for seven years she put money away until she had enough to finally purchase her ticket.

From the time she boarded the ship, Hazel loved the carefree atmosphere. She immediately met new friends and spent most of her days with them on the upper deck relaxing in the sunshine and enjoying the sea breeze.

The only discomfort Hazel faced was at mealtime. She would make excuses to her new friends that she didn't feel well so she could go to her cabin. Tears would fill Hazel's eyes as she watched on while her friends went to the dining room, laughing and joking.

Hazel boarded the ship with her private stockpile of food, which she had carefully planned and prepared at home. So, during the entire cruise she went alone to her cabin at mealtime where she ate sandwiches, cheese, and fruit because she knew she couldn't afford to dine with the others. Hazel's vacation ended without her discovering that **ALL MEALS HAD BEEN INCLUDED IN THE PRICE OF THE TICKET!**

Hazel never considered that the meals were prepaid, and the travel agent never told her because he assumed she knew. Sadly enough, Hazel experienced what she expected and turned down a paid benefit. We all have some "Hazel" in us, often letting expectations blind new experiences or opportunities. Don't settle for cookies when you can have baked Alaska!

Believe in your right to abundance

SAMUEL AND JONATHAN

A parable tells about two men from separate villages who travel to the same marketplace in a nearby city to trade their wares. When he arrived at the city gates, the first man, Samuel, met an old man resting under a tree.

Samuel said, "Tell me, sir, what is your city like. This is my first visit and I want to make sure I get a high price for my merchandise."

"Before I answer, tell me what it is like where you live," replied the old man.

"My people are sneaky and dishonest," answered Sam, "They cannot be trusted. I work and then must watch over my fields so others won't steal my crops or trample my vines. It is a miserable world."

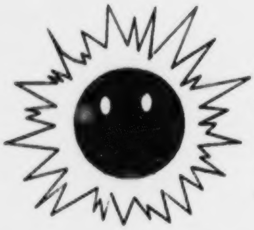
"I'm sorry to report that the people in this city are similar to those in your village. They also will rob you blind," warned the old man. With that warning, Sam entered the city.

The second visitor, Jonathan, arrived shortly after Samuel. Jonathan saw the same old man under the tree, and asked him what the people were like in his city. Before replying, the old man again asked what the people were like in Jonathan's village.

Jonathan said, "My people are friendly, honest, and fair. We help each other as much as possible. Several times in my life I have had bad luck, but with the help of neighbors and friends I pulled through. Today I am trading goods for a newcomer to our village who has a broken leg. I would like to see him get a fair profit."

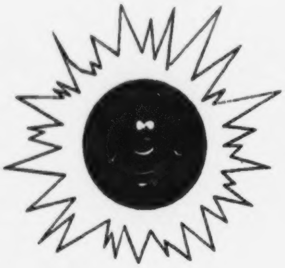
"You will find the people in our city much like those in your village. They are friendly, helpful, and trustworthy. They will be good to you," the old man answered. Jonathan thanked him and continued his journey.

That evening when Samuel left the city, the old man was still under the tree. As he passed by in his wagon, the old man shouted, "Tell me sir, how did the people in our city treat you?"



"I had a horrible day," Samuel replied. "Your people are as disagreeable as mine. Several tried to cheat me. The rest wouldn't pay a decent price for my goods. They are a wretched sort, and because of them I barely broke even. I hope to never return." With head bowed, Samuel left for his long, difficult journey home.

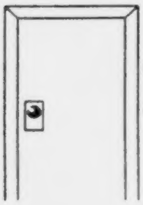
Jonathan followed behind Samuel. The old man also asked him about his day. With a smile, Jonathan replied, "The people were first-rate, just like you said. A strange lady helped me find a good spot. I gave one man a good price, and he brought all his relatives over to make purchases. I am leaving with a healthy profit for myself and my friend. The people in your city are wonderful, and I look forward to my return."



Expectations are magnetic. Whether conscious or unconscious, they will rule your behavior. **WHAT YOU EXPECT, YOU FULFILL.** Therefore, assume you will have wealth (or more wealth), and you will see money making opportunities. What you expect usually happens.

Your expectations are magnetic.
They repel or attract
your dreams

Attitude

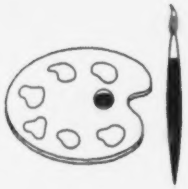


A person with a positive outlook views a closed door as an opportunity to change direction. He will find fertility in a desert. He sees animal life under shaded rocks, and notices plants and wildflowers living in rocky crevices.

Similarly, a person with a negative outlook will see an open door as a threat to his security. He will see barrenness in a rain forest abundant with life. Because he is concerned the dampness might bring on a cold, he doesn't notice the lush foliage. Instead, he fears that an insect might bite him, or he will run into a poisonous plant. The colorful, tropical birds sing to mute ears.

Your attitude influences your reactions

Attitude decides an experience of abundance in a desert, or barrenness in a verdant forest. We are just beginning to understand that thoughts, although intangible, have tremendous power. They can be used to improve the quality of life. **POSITIVE THOUGHTS CAN CHANGE PERSPECTIVE, TRANSFORM OLD BEHAVIORS, AND ATTRACT GOOD FORTUNE.**



Outlines in coloring books remain obscure and lifeless until filled in with colors. The colors can be drab or cheery; they can clash or blend. In the same way, our emotions "color" the various situations we experience. **UNTIL WE REACT, THE EVENT IS NEUTRAL. WE GIVE A SITUATION MEANING THROUGH OUR ATTITUDE AND POINT OF VIEW.**

ANTI-PROSPEROUS ATTITUDES

To invite good fortune and success, learn to overcome anti-prosperous attitudes such as:

- ✓ It is his fault that I didn't get the promotion.
- ✓ If I share, there won't be enough for me.
- ✓ My expenses increase when I have more money, so why try to get ahead?
- ✓ I can't do this.
- ✓ I won't pay one dime more than my share!
- ✓ I earned my money the hard way. They can do the same.

Blame

It's easy to blame others for life's commonplace hurts and frustrations. The boss who overlooked a promotion, the child who ruined a new tool, or the slow checker in a long grocery line. Blaming others for a pain or an inconvenience only adds to the problem and seldom makes the situation better.

Positive solutions exist for most problems, but they are far removed from blame. **BLAME IS A QUICK REACTION THAT PUTS RESPONSIBILITY FOR YOUR FRUSTRATION 'OUT THERE.'** Most importantly, it never solves the problem. Cultivate your own garden, and let others do the same.

Scarcity

Scarcity is a belief that originates in fear and feeds on self-sacrifice. It says:

- ✓ There is not enough for everybody
- ✓ Life is a continual battle

Life is an uphill battle

IF YOU VIEW LIFE AS A BATTLE, YOU WILL NEED TO KEEP 'FIGHTING.' If you expect to be a victim, you will be dumped on with regularity. When this happens, working harder doesn't help you get ahead and the work is not fulfilling. This reinforces the negative outlook that life is a continual battle. To partake of the harvest, you must feel deserving. If you can change your beliefs to see an abundant world with ample resources and opportunities for everyone, you can stop fighting and start giving thanks.

Accepting responsibility puts you in charge

More Is Better

Some people believe financial success means dining out more often, a bigger house, a newer car, or more clothes. We tend to equate financial success with more possessions such as boats, luxury cars, and fine furniture. These things are only symbols of success.

MANY WORK TO ACHIEVE THE SYMBOL RATHER THAN WHAT THE SYMBOL REPRESENTS. They spend all the money they earn, then keep buying, not realizing possessions offer no real security and are a front for true wealth. Later, they realize owning more is not always better.

Sometimes a focus on getting more actually promotes a lesser life. This is especially true for those who buy beyond their means. They desire security, but burdensome monthly payments cause insecurity. **SECURITY CANNOT BE BOUGHT. IT DOES NOT COME FROM POSSESSIONS; IT COMES FROM WITHIN.**

People care more about how you treat them than what you own. So when you think "more stuff" enhances your life, step back and take an objective look. How do possessions complement your life and add to your self-worth?

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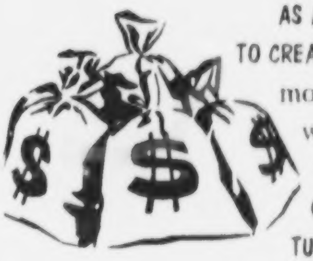
Procrastination

We often think that tomorrow will bring more money, more time, stronger convictions, or greater happiness. The future always holds the promise of turning visions into reality. The thinking usually is: tomorrow I'll have increased abilities, tomorrow I'll have more time, tomorrow I'll have more money, tomorrow I'll be happier. The truth is, desires only materialize by taking steps today to improve skills, to save money, and to make time for what is important to you.

We Usually Think:
Tomorrow I'll have more time. . .
Tomorrow I'll have more money. . .
Tomorrow I'll be happier. . .

ARE YOU AND PROSPERITY COMPATIBLE?



AS A RULE, WHEN WE EXPECT GOOD FORTUNE, WE FIND THE RIGHT SET OF CIRCUMSTANCES TO CREATE IT. Remember, neither God nor the universe will send an instant promotion or put funds into your bank account. Because you want more wealth doesn't mean you will find a bag of money on your doorstep. Wishing isn't enough. Life doesn't work that way. **INSTEAD, LIFE GIVES US OPPORTUNITIES AND THE FREE WILL TO MAKE CHOICES. OFTEN, MISFORTUNE IS OPPORTUNITY IN DISGUISE.** It can end a present direction that is not working and bring in a new one that will.

Opportunities are everywhere, but we must be positive and clear thinking to recognize them. Muddled thoughts make decisive action difficult. **CLEAR THINKING PRECEDES DETERMINED ACTION. CAN YOU IMAGINE YOURSELF AS SUCCESSFUL, PROSPEROUS, AND HAPPY?** If you can't, you won't be. Your emotional acceptance is essential to its achievement.

THE FOLLOWING STORIES TELL ABOUT TWO PEOPLE WHO RECEIVED LARGE SUMS OF MONEY AND, IN BOTH CASES, LOST IT. If used wisely, this money could have created lasting prosperity for them. As it turned out, their good fortune made only temporary changes in their life and no permanent improvements in their lifestyle.

THE WESTONS

Mr. Weston, inherited $250,000 from an uncle. At the time, he and his wife were living in a small trailer with their six children. Until the inheritance came, the Weston family was always broke. They never had enough money to make ends meet.

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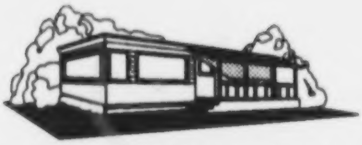


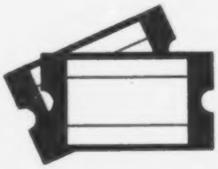
If the Westons had thought about their lifetime goals and dreams, they would have set aside money to buy their first home. Then, they would purchase life insurance, put money in savings to cover emergencies, and open a college fund for each of their children. As a bonus, they might even plan a vacation. **THEY HAD AN OPPORTUNITY TO STOP STRUGGLING AND START BUILDING THEIR DREAMS.**

Unfortunately, they did not consider any long-range goals. Two years later their circumstances had not changed. Instead of using a financial plan to direct their money, they went on a spending spree. This included dining often in expensive restaurants, buying new cars, new clothes, bikes, and televisions. They bought everything but a house! $250,000 disappears quickly without a plan.

As incredible as it seems, within twenty-four months the Weston family still resided in their overcrowded trailer with no money in the bank. After spending their inheritance, they were again struggling from paycheck to paycheck. The once shiny new cars became tarnished through neglect.

Obviously, Mr. and Mrs. Weston never learned how to take care of their possessions, or how to use money to get ahead. Their habits were based on anti-prosperous attitudes. **HAVING MORE MONEY MADE NO IMPROVEMENT IN THEIR LIFESTYLE BECAUSE THEY DID NOT USE IT WISELY. THEIR SELF-WORTH DID NOT MATCH THE MONEY THEY RECEIVED.**

GEORGIA JOHNSON



Georgia Johnson won $100,000 at a race track. Georgia went into shock when she talked to her tax advisor and discovered the taxes due would be more than her current salary. She could not concentrate on the positive—the $75,000 left after taxes.

Georgia was in her late forties and hated her job. The $75,000 left after taxes, used wisely, would be enough to fulfill her goal of early retirement and allow her to stop working at age 55, ten years earlier than she had hoped. What an opportunity!

Unfortunately, Georgia never could get beyond giving up the $25,000 for taxes. She wanted the full $100,000. Her reward was still there, but she failed to see it. She had enough money left to reach her goal although she lost one-fourth to taxes. Governments always tax income. Large gifts usually have strings attached and seldom come "free." Life is never 100% our way, but a continual compromise.

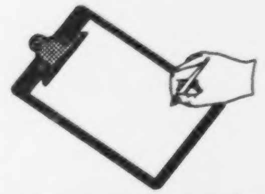
Yet, Georgia still wanted 100%. So, putting wise counsel aside, she invested in some high risk tax shelters. She tried not only to avoid taxes, but also tried to triple her winnings in a few short years. Had her plan worked, she would have been extremely lucky twice in a row. As it turned out, she lost most of her money. Will she now retire early? Will she ever pursue the hobbies she loves? It's doubtful. She missed an opportunity to turn her life around because she wasn't willing to "pay her dues." Her expectations fell short of her winnings.

IF YOU DON'T EXPECT PROSPERITY, IT WON'T HAPPEN. Your expectations control the opportunities you recognize and therefore experience. Low expectations generate little opportunity. High expectations generate boundless opportunity. With low expectations, large sums of money can disappear quickly, and yet with high expectations, small sums of money can increase many times over.

Your self-worth decides your net worth

Chapter 3

Financial Inventory



A financial inventory shows you where you are now. From this starting point, look at the big picture and decide where you want to go. Knowing both your starting point and your destination helps plan your money. **IT IS A GOOD IDEA TO ASSESS YOUR CURRENT POSITION SO YOU KNOW WHAT RESOURCES YOU HAVE WORKING FOR YOU.** How much money do you earn? How much do you spend? What do you own, and how much do you owe on those assets?

The cash flow statement and net worth statement discussed in this chapter are tools for taking a financial inventory. They show you where you are, and help you find ways to get to where you want to be. **A CLOSE SCRUTINY OF THESE STATEMENTS WILL UNCOVER POTENTIAL WEAKNESSES AND HELP YOU OVERCOME THESE WEAKNESSES BY IMPLEMENTING NEW STRATEGIES.**

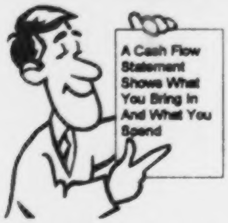
Many who have sought professional financial planning say the planning session was valuable because they took the time to:

- ➜ Look at their assets and liabilities
- ➜ Look at their income and expenses
- ➜ Discuss financial goals with family members

Analyzing on paper what happens to your money takes time, but gives you important information. It provides working tools to improve your cash flow and initiate a healthy, growing net worth.

CASH FLOW

Cash Flow Statement


A Cash Flow Statement Shows What You Bring In And What You Spend

A cash flow statement shows your inflow and outflow, that is, what you bring in and what you spend. It can be simple or detailed. The more out-of-control your spending, the more itemization and inquiry needed toward your income and expenses.

THE CASH FLOW STATEMENT COMPARES MONEY EARNED TO MONEY SPENT. The numbers are specific, gleaned from pay stubs, checks, and bills. If, like most people, you need everything you earn and then some just to meet your expenses, don't get discouraged. Eventually, you will learn how to find "hidden pockets" that can free extra money to work for you.

After looking over the sample cash flow statement in Table 3.1, take a sheet of paper and follow its format: at the top write **CASH FLOW,** and today's **DATE.** On the left write **INCOME;** on the right **EXPENSES.** Using Table 3.1 as a guide, you will need to put down the income and expense headings that fit your situation.

CASH FLOW

Date

Income	Expenses

GET YOUR DATA BY LOOKING AT A TYPICAL MONTH'S INCOME AND EXPENSES. If possible, use the most recent month. You will need copies of pay stub(s), bills, check book register(s), and a calculator. **IF YOUR EMPLOYER PAYS YOU WEEKLY OR BIWEEKLY, CONVERT THESE AMOUNTS TO A MONTHLY GROSS INCOME.**

BEGIN BY LISTING GROSS INCOME FROM ALL INCOME SOURCES such as salary(ies), pension(s), tips, alimony, child support, and social security. If you have income that varies, such as tips, bonuses, commissions, or royalties, go back six (6) months to get an average. Use that average as the month's income.

AFTER FINISHING WITH ALL YOUR INCOME, LIST YOUR EXPENSES. SOME OF THESE WILL BE FIXED MONTHLY EXPENSES. That is, they remain the same each month. Start with the amounts taken out of your pay for fed-

Table 3.1 CASH FLOW STATEMENT

INCOME:	**EXPENSES:**
Fixed	*Fixed*
Salary 1	Federal Taxes
Salary 2	FICA Taxes
Other	State Taxes
Other	Health Insurance
Variable:	Mortgage / Rent
	Auto Payment(s)
	Auto Insurance
	Variable
	Auto Service/Gas
	Food
	Household Expenses
	Other
	Other
	Savings
TOTAL INCOME	TOTAL EXPENSES
Net Income After Expenses	

eral, state, and employment taxes (FICA and Medicare). Then look at other payroll deductions such as retirement contributions, health and life insurance, loan payments, and savings plans.

Paycheck

Deductions:
Federal Tax $ . . . .
State Tax $ . . . .
FICA $ . . . .
Medicare $ . . . .
Insurance $ . . . .
Loans $ . . . .

Next, list mortgage or rent payment(s) and car payment(s), then all other fixed payments such as insurance. **IF YOU PAY INSURANCE OR OTHER EXPENSES ANNUALLY OR QUARTERLY, CONVERT YOUR PAYMENT TO A MONTHLY EXPENSE.**

Variable expenses include amounts that change from month to month such as charge card payment(s), food, recreation, and clothing. When payments vary, such as food or recreation, take a six month average (add the total expense for six months, then divide this total by six). Education, contributions, and child care could be either a fixed or a variable expense.

WHEN YOU HAVE WRITTEN DOWN ALL OF YOUR MONTHLY EXPENSES, TOTAL YOUR INCOME AND YOUR EXPENSE COLUMN. THE FINAL STEP IS TO SEE HOW MUCH INCOME YOU HAVE LEFT AFTER PAYING ALL EXPENSES.

Table 3.2 shows a completed monthly cash flow statement for a family of four. The averages are based on studies by the U.S. Bureau of Labor Statistics.

Table 3.2 COMPLETED MONTHLY CASH FLOW STATEMENT SHOWING PERCENTAGES

INCOME:			**EXPENSES:**		
Fixed		%	*Fixed*		%
Salary 1	3,200	69%	Federal Taxes	288	7.0%
Salary 2	978	31%	FICA Taxes	320	7.6%
Other			State Taxes	174	4.2%
Other			Health Care	111	2.7%
Variable			Housing	993	24.0%
			Transportation	705	17.0%
			Insurance/Pension	466	11.0%
			Variable		
			Entertainment	165	4.0%
			Food	459	11.0%
			Education	49	1.0%
			Contributions	159	3.8%
			Clothing/Personal	247	6.0%
			Miscellaneous	4	.7%
TOTAL INCOME	4,178	100%	TOTAL EXPENSES	4,140	100.0%
	Net Income After Expenses		**$38**		

Analyzing Your Cash Flow

✓ **WHAT PERCENTAGE OF TOTAL MONTHLY INCOME GOES TOWARD TOTAL MONTHLY EXPENSES?** If total income is $1,500 and total expenses are $1,400, expenses are 93% of income. Divide total expenses by total income ($1,400 ÷ $1,500 = 93%). Seven percent is left after expenses.

✓ **WHAT PERCENTAGE IS EACH EXPENSE ITEM?** If total expenses are $1,400 and you spend $450 for rent, then rent is 32% of total expenses. Divide each expense item, such as rent, by the expense total such as $1,400 ($450 ÷ by $1,400 = 32%). Know what percentage you pay for taxes, food, auto repairs, installment debt, etc.

✓ **DO SOME EXPENSE AREAS SURPRISE YOU?** Are they greater or smaller than you expected? What are these areas? Why are you surprised?

✓ **WHAT EXPENSES WILL REDUCE OR END IN THE FUTURE?** (They may be car loans or other debt when paid off.) When will they stop or be reduced?

✓ **DO YOU HAVE MONEY GOING INTO SOME TYPE OF SAVINGS OR INVESTMENTS? WHAT PERCENTAGE?**

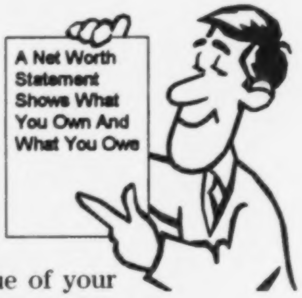
✓ **WHAT EXPENSES, IF ANY, CAN YOU REDUCE?**

✓ **DO YOU HAVE TOO MUCH INSTALLMENT DEBT?** What would your situation look like without it or with a smaller percentage of debt?

YOUR COMPLETED CASH FLOW STATEMENT, WITH PERCENTAGES BY EACH EXPENSE ITEM, IS A TOOL. It will help you take charge of your spending instead of expenses directing you. If you are not pleased with your cash flow, try to channel more money into areas that are important to you, and cut back on ones that aren't.

TAKE TIME TO DO THIS CASH FLOW ANALYSIS. TO WORK, IT MUST BE WRITTEN AND PUT DOWN IN THE FORMAT DISCUSSED. A completed cash flow analysis gives you specific information that will help you take charge of your money. **SOLUTIONS ARE NOT POSSIBLE UNTIL YOU KNOW THE PROBLEM.**

NET WORTH


A Net Worth Statement Shows What You Own And What You Owe

Net Worth Statement

A NET WORTH STATEMENT IS THE SECOND IMPORTANT TOOL FOR TAKING YOUR FINANCIAL INVENTORY. It is a personal balance sheet showing the value of your assets and the balance of your debts. **BASICALLY, IT REVEALS THE ASSETS YOU HAVE WORKING FOR YOU AND HOW MUCH YOU OWE ON THEM, IF ANYTHING.**

A$$ET$ Again, on a piece of paper write **NET WORTH** at the top, and under it, today's date. Divide the paper in half; on the left write **ASSETS** and on the right, **LIABILITIES.** Under assets, list the market value of each asset you own. On the right, list the

LIABILITIES

balance owing on all of your loans. When finished, total the amounts for both columns. Your **NET WORTH** is your **ASSETS** minus your **LIABILITIES.** Use Table 3.3 as a guide.

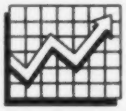
BE SURE TO LIST THE TOTAL MARKET VALUE FOR ALL MAJOR ASSETS, AND THE BALANCE OWING ON ALL LOANS OR CREDIT CARDS. If you own a home and it is worth $120,000, list the full market value as an asset under "Home." If you owe $80,000 on the mortgage, list the $80,000 loan as a liability under "Home Mortgage." Your home equity is $40,000, the difference between the market value and the balance on the loan. Equity adds to your net worth.

Table 3.3 NET WORTH STATEMENT

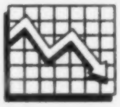
ASSETS:		LIABILITIES:	
List Market or Cash Value		*List Total Balance*	
Checking	%	Mortgage	%
Savings			
Life Ins. Cash Value		#1 Car Loan	
Stocks		#2 Car Loan	
Mutual Funds		Credit Card	
Annuities		Credit Card	
Pension (Vested)		Credit Card	
Residence		Loan Balance 1	
Automobiles		Loan Balance 2	
Rec. Vehicles		Loan Balance 3	
Furniture			
Valuables			
TOTAL ASSETS		TOTAL LIABILITIES	

NET WORTH *(Assets Minus Liabilities)*_______________

What Is Your Net Worth?



- → **IDENTIFY THE ASSETS THAT ARE GROWING** in value each year.



- → **IDENTIFY THE ASSETS THAT ARE DECREASING IN VALUE?** (i.e., cars, home furnishings, etc.)

→ **WHAT ASSETS CAN YOU EASILY LIQUIDATE,** such as savings accounts and money market funds? **DO YOU HAVE SUFFICIENT LIQUID ASSETS** to cover an emergency?

→ **COMPARE LIQUIDITY WITH NON-LIQUIDITY.** Some people today are "asset poor." They have too much money tied up in real estate, pension plans, or hard assets and works of art that can not be sold easily if cash is needed. Their net worth looks great on paper, but they have nothing in the bank to see them through an emergency.

→ **IS YOUR NET WORTH GROWING FAST ENOUGH TO KEEP AHEAD OF INFLATION AND TAXES?** If you have large amounts of equity with little growth, consider freeing the equity so it can better serve your needs. This means selling the asset or borrowing against it. Such repositioning can also create greater liquidity and possibly provide some tax relief. The examples given later in this book will show how.

A PRIMARY FINANCIAL GOAL SHOULD BE HAVING A NET WORTH THAT GROWS EACH YEAR. Net worth increases by acquiring more assets, by present assets going up in value, or by reducing liabilities. The higher your net worth, the more money you have working for you.

YOUR CASH FLOW STATEMENT CAN HELP YOU IMPROVE YOUR NET WORTH, AND YOUR NET WORTH STATEMENT CAN HELP YOU IMPROVE YOUR CASH FLOW. STUDY THEM TOGETHER AND LOOK FOR SOLUTIONS IN THE ONE THAT SEEMS TO HAVE THE LESSER PROBLEM. Often, the solution to a poor cash flow can be found through analyzing net worth, and the solution to a poor net worth can be found through analyzing cash flow. For example, your net worth statement may reveal you have a large amount of equity in your home. Your cash flow statement shows you have two car loans and several credit card balances, all with high interest charges. A home equity loan at a lower interest rate might help you reduce your monthly payments, reduce your taxes, and free some money for savings. (See *Home Equity Loan*, p. 136, and *Interest Expense*, p. 85.)

Your cash flow statement might show you have money left after meeting necessary expenses, but none of it is going into savings. If this is the case, you could start increasing your net worth by getting a handle on money spent unnecessarily.

CONTINUAL SCRUTINY OF YOUR CASH FLOW AND NET WORTH HELPS YOU USE MORE OF YOUR INCOME TO ACCUMULATE ASSETS THAT GROW IN VALUE AND ALSO HAVE ENOUGH LIQUIDITY TO MEET UNEXPECTED EXPENSES.

**The higher your net worth
the more money you have
working for you**

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Chapter 4

Basic Money Rules

To get from where you are to where you want to be, you will need to use some basic money rules. Money at work is dynamic. Back in 1778 Ben Franklin wrote:

> *"MONEY IS OF A PROLIFIC, GENERATING NATURE.*
> *MONEY CAN BEGET MONEY, AND ITS OFFSPRING CAN BEGET MORE."*

TO BUILD A FORTUNE, YOU MUST PUT YOUR MONEY TO WORK. Earning a high salary does little good unless some of that money also starts producing. When you save just a few dollars from each paycheck, eventually these dollars will earn more than you—that is, if you give them enough time.

To accumulate wealth, you must put your money to work

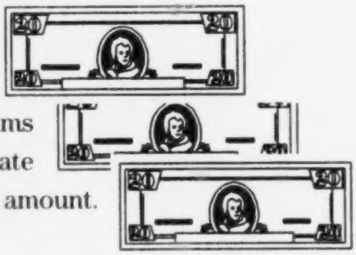
SHORTCUTS DO NOT WORK

Shortcuts to financial success seldom work. You gain wealth through joining **MONEY, TIME, AND GROWTH.** All three must be present for lasting results, with no exceptions to this basic rule. Unless you are an heir to a sizable estate, you need to get some of your money working for you.

To accumulate wealth you need:
- ✓ **Money**
- ✓ **Time**
- ✓ **Growth**

Money at work is the only reliable way to build a nest-egg. All you need is an average wage and enough discipline to save consistently. **THE DISCIPLINE TO CONTINUE PUTTING MONEY ASIDE EVERY MONTH IS MORE IMPORTANT THAN THE DOLLAR AMOUNT YOU SAVE.** You can accrue an impressive balance with just a few dollars saved consistently over **TIME.**

The Importance of Money



To take advantage of Ben Franklin's idea and get money working for you, you need to first come up with the capital. Many people have built sizable fortunes through saving small sums consistently, then allowing **TIME** and the **RATE OF RETURN** to generate results. First you need the extra **MONEY**, even if it is a small amount. Without it, nothing can happen.

The Importance of Time

MONEY and **TIME** work together. More **TIME** permits fewer dollars to grow into sizable accounts. Money at work, however, doesn't double overnight. Just as apple trees need time to develop before they bear fruit, earnings need to mature before they start producing.

If you can't take advantage of **TIME**, it will be more difficult to accumulate wealth. **PEOPLE WAITING UNTIL THEIR FIFTIES TO SAVE AND INVEST WILL NEED TO PUT AWAY OVER FOURTEEN TIMES MORE THAN THOSE WHO START SAVING IN THEIR TWENTIES.** By starting **MONEY** compounding early, you need fewer dollars to build an impressive account. Those in their twenties have an advantage; they have time on their side. This advantage, if used regularly, will guarantee financial success.

If you have little money, you can use time to build a large account

Table 4.1 illustrates **THE TIME MIRACLE.** It shows how much money you need to save monthly at different ages to have $100,000 in today's dollars at age sixty-five if the money grows at 6%.

Table 4.1 THE TIME MIRACLE

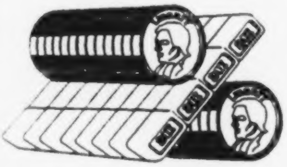
AGE	MONTHLY AMOUNT NEEDED TO HAVE $100,000 AT AGE 65 @ 6%
25	49.96
30	69.84
35	99.06
40	143.58
45	215.35
50	342.15
55	607.17

Notice that you need to save over four times more at age forty-five than at age twenty-five to reach the same goal. By age fifty-five, with only ten years left, you need twelve times more! No wonder so many people in their fifties say, "Why didn't someone tell me to start saving when I was twenty?"

More time creates wonders. For instance, $25 saved once a month, earning an annual yield of 6%, becomes $25,238 in thirty years. Yet, in just ten more years this $25 per month almost doubles to $50,036! As you can see, small amounts grow significantly with enough time. If you only have a little money to save, you can compensate by putting time to work, and time is free.

The longer you wait,
the more you have to save
to achieve a desired amount

The Importance of Growth (Rate of Return)



MONEY and **GROWTH** also work together because money invested doubles, then redoubles, at a pace set by the rate of return it receives. For most people, getting rich quick through an excessive return doesn't work, but neither does a low return that fails to keep pace with inflation and taxes. **TO GET AHEAD, YOUR MONEY MUST EARN MORE THAN AVERAGE PRICE INCREASES.**

To get ahead,
your money must earn more
than average price increases

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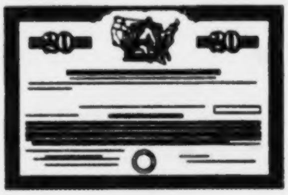
INVESTMENTS THAT TAKE ADVANTAGE OF FAVORABLE MARKET CONDITIONS WILL HELP YOU EARN MORE ON YOUR MONEY. Generally, the reward of higher earnings offered on low to medium risk investments are worthwhile. You should avoid high and speculative risks offered through deals "to get rich quick" unless you are willing to gamble some or all of your principal. Few win and many lose in these ventures. **ON THE OTHER HAND, A LOW, GUARANTEED RATE OF RETURN MAY YIELD A LOSS OF PURCHASING POWER AFTER INFLATION AND TAXES TAKE THEIR SHARE.** To get ahead, money needs to earn more than cost of living increases (see *Break-Even Rate of Return*, in Chapter 16, *Planning*).



A higher rate of return generates higher profits. For instance, $10,000 earning 3% grows to only $18,180 in twenty years; but $10,000 earning 9% grows to $59,301 in twenty years. At 12% this same $10,000 will grow to $106,409 in twenty years. Compounding at the higher rate produces nearly six times more money (from $18,180 to $106,409). Examine Table 4.2 to see the results of saving only $25 per month ($300 a year) at four different compound returns: 3%, 6%, 9%, and 12%.

Table 4.2 RESULTS OF SAVING $25 PER MONTH

	$25 SAVED PER MONTH			
	3%	6%	9%	12%
20 Years	$8,228	$11,609	$16,822	$24,979
30 Years	$14,605	$25,238	$46,112	$88,248
40 Years	$23,209	$50,036	$117,911	$297,061

Notice that saving $25 per month at 6% produces $50,036 in forty years; but, at 9% the total grows to $117,911, and at 12% it reaches an incredible $297,061! Not bad for a $12,000 investment.

Compound Interest and the Rule of 72

Your money grows in a savings account by earning compound interest. The interest "compounds" when it is added to the principal where it will earn interest for the next time period. The earnings are computed at the end of a compounding period, which can be daily, weekly, monthly, quarterly, or annually. The more frequent the compounding, the higher the yield, because each time the principal grows it earns more interest.

LOAN APPLICATION

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Ben Franklin understood well how money grows and compounds over time. He left $5,000 to the city of Boston in 1791, with instructions that it should be left alone to compound for one hundred years. The $5,000 grew to $322,000 by 1891. The city built a school with some of the money, but also followed Ben's wishes to set aside $92,000 for another hundred years. By 1960 this fund had grown to $1,400,000![1] Although you probably won't save your money for a hundred years, the dynamics of compounding also can work for you.

RULE OF 72

Divide 72
by Rate of Return

Answer Equals Years Needed
For Principal to Double

You will find the ***RULE OF 72*** valuable for predicting money growth on compound rates of return. **THIS RULE SHOWS HOW MANY YEARS ARE NEEDED FOR A SUM TO DOUBLE AT VARIOUS RATES.** Simply divide 72 by the rate of return, such as 6%. The answer tells the number of years needed for the principal to double.

For example:
$500 earning **6%** doubles to $1,000 in **12 years** (72 ÷ 6% = 12)
$500 earning **12%** doubles to $1,000 in **6 years** (72 ÷ 12% = 6)

Table 4.3 shows $1,000 at work at annual compound rates varying from 4% to 12%. The rate decides the number of years needed for the principal to double, then redouble, again and again.

Table 4.3 RULE OF 72

$1000 will double in this many years	**4% 18 years to Double**	**6% 12 Years to Double**	**8% 9 Years to Double**	**12% 6 Year to Double**
6 Years				$2,000
9 Years			$2,000	
12 Years		$2,000		
18 Years	$2,000		$4,000	$8,000
24 Years		$4,000		$16,000
27 Years			$8,000	
30 Years				$32,000
36 Years	**$4,000**	**$8,000**	**$16,000**	**$64,000**

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Notice the wide spread in the thirty-sixth year—a $4,000 total from a 4% yield compared to a $64,000 total from a 12% yield. Three times more interest (4% to 12%) does not net three times more money—it yields sixteen times more money ($4,000 to $64,000)! The higher rates that double in fewer years can create fortunes with only a few dollars.

INVESTMENTS

Although 12% is higher than current market rates, it demonstrates the dynamics of compound growth. The last time we saw 12% interest rates paid by savings institutions was back in the late seventies. Several mutual funds today, however, advertise an annual compound rate of return close to 12%. The compounding from these funds comes from reinvested capital gains and dividends that are paid annually or quarterly. These funds have no guarantees, but over a five year period or longer, the risk might be minimal and worth the potential increased profits.

Simple and Compound Rates Compared

Simple interest rates use a different method to calculate rates of return. They are used with investments such as stocks, income producing limited partnerships, and mutual funds. If a mutual fund company converts their yield to a compound rate, their literature will clearly state so. Otherwise, assume the rate is "simple." With simple rates the principal does not compound as illustrated in the **RULE OF 72**. If you invest $1,000, then six years later sell the investment for $2,000, you made a $1,000 profit, or 100% on your money. **WITH SIMPLE RATES, THE INVESTOR EARNS 100% EACH TIME THE PRINCIPAL DOUBLES.** Since it took six years in this illustration, the total profit divided by six (number of years) gives the annual yield of 16.7%. (100% ÷ 6 = 16.7%). Or, the profit per year, $167, can be divided by the principal ($1,000) to get the same 16.7%.

Simple Interest

The 16.7% **SIMPLE YIELD** used in this example is equivalent to a 12% **COMPOUND YIELD. THAT IS, IN SIX YEARS, $1,000 EARNING 12% COMPOUND INTEREST GROWS TO $2,000; AND, IN SIX YEARS, $1,000 EARNING A 16.7% SIMPLE RATE OF RETURN ALSO GROWS TO $2,000.**

Assume a stock or mutual fund advertises a 20% annual yield. This means the earnings paid to investors would be $200 for each $1,000 invested ($200 ÷ $1,000 = 20%). **MOST INVESTMENTS CALCULATE YIELDS USING THE SIMPLE METHOD. BE REALISTIC IN MAKING COMPARISONS AND DON'T THINK THE SIMPLE RATE IS ALWAYS BETTER BECAUSE IT IS HIGHER.** For example, if $1,000 earns a 14.4% compound return, the net result is the same as a 20% simple return. In both accounts, the money doubles in five years ($1,000 grows to $2,000).

Most Investments calculate yields using the simple method

Compare rates of return by looking at the number of years needed for your investment to double

Since compound and simple rates are calculated differently, the best way to compare them is to look at how many years it takes for a given sum to double. This approach allows investors to make true comparisons between options using different payment methods.

Table 4.4 compares **SIMPLE** and **COMPOUND YIELDS** by showing the years it will take for the amount invested to double. If you can receive a guaranteed 6% compound return, it makes no sense to take more risk to receive a higher simple rate of 8.3%, because the profits are the same.

When the profit is the same, don't take more risk for higher yields

Table 4.4 COMPARISON OF SIMPLE AND COMPOUND YIELDS

Years to Double	Compound Rate	Simple Rate
14.4 Years	5%	6.9%
12.2 Years	6%	8.3%
10.3 Years	7%	9.7%
9 Years	8%	11.11%
8 Years	9%	12.05%
7.2 Years	10%	13.9%
6.5 Years	11%	15.4%
6 Years	12%	16.6%
5 Years	14.4%	20.0%

WHEN COMPARING GROWTH OPPORTUNITIES, KEEP THE ANTICIPATED END RESULT IN MIND. Look at the earnings paid to investors over the years and how these earnings have fluctuated. Also realize that past performance is no guarantee for future performance, but it is the best single indicator we have. Compare an investment's simple yield to the compound rate currently paid by banks and credit unions. What is the difference in earnings?

Look at the variations. Some mutual funds that pay consistent dividends convert their simple yield into a compound yield for ease of comparison. If this is the case, it will be clearly stated in the fund's literature, such as:

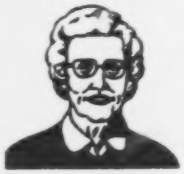
> *This fund has averaged a 12.3%* **COMPOUND** *rate of return for XX years when all dividends and capital gains are reinvested.*

On the other hand, some Certificates of Deposit (CD's) do not automatically compound the earnings. CD's pay a simple return for a certain time period. You can take the earnings in cash or reinvest them.

The difference between the two payment methods is that a **SIMPLE RETURN DOES NOT AUTOMATICALLY ADD THE EARNINGS TO THE PRINCIPAL TO INCREASE ITS VALUE.** The following story compares the long-term results of simple and compound rates of return.

SUE'S "SIMPLE" STORY

When Sue was born, her grandfather gave her a gift of $5,000. He placed the money in a certificate of deposit in her name at a local bank. The bank offered 11% interest if the certificate wasn't cashed in for fifty years. He left instructions that Sue was not to have the money until her fiftieth birthday. He thought he had invested prudently, but he failed to ask the bank how they paid interest. He never knew that it was a **simple rate,** paid annually.



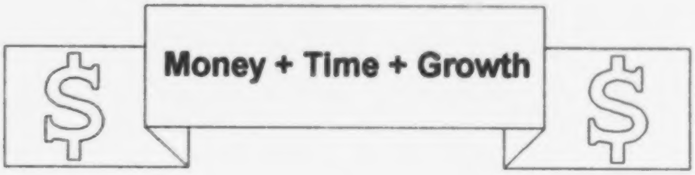
Sue's grandmother also opened an account for Sue. The grandmother took $5,000 of her money and went to another bank. She also locked in an 11% interest rate for the next fifty years. Unlike her husband, she made sure Sue would receive **compound interest** on this account.

On Sue's fiftieth birthday, she went to the bank to withdraw the money her grandfather had set aside for her when she was born. The balance was $32,500. It had continued to pay 11% simple interest all this time, or $550 each year ($5,000 x 11% = $550). In fifty years, the earnings had grown to $27,500 ($550 x 50 = $27,500). Adding the $27,500 of earnings to the $5,000 principal equaled the current balance of $32,500.

Then, she drove across town to check on the account opened by her grandmother. Much to her surprise, she discovered that this account was worth $922,824. Receiving the 11% annual compound return since she was born meant that the bank added her interest to the principal annually. The first year she received 11% on $5,000; the second year, 11% on $5,550; then the third year, 11% on $6,161, etc. As the principal grew, her earnings increased. With compound interest, the principal keeps expanding to earn even more.

Just think, Sue had $955,324 when she retired from a $10,000 investment at work for her for 50 years. Of course, without a compound return, she would only have had $65,000 ($32,500 x 2). On the other hand, if both accounts had earned compound interest she would have retired with $1,845,648.

MONEY, TIME, AND GROWTH ARE ALL NECESSARY TO PUT YOUR DOLLARS TO THEIR WISEST USE. Once you come up with the money, look at the time period you expect it to be invested. Growth makes an important difference in how quickly the money doubles. If you expect too much growth too quickly, you could lose it all. Chapter 9, *Investments*, tells about different opportunities to get higher rates of return.



PART
II

How Money Disappears

Hopefully, some of the dollars that you earn will multiply and grow to meet your future needs. Unfortunately, others will disappear before you get to use them. If you can identify where these dollars disappear, you might be able to put some of them to work for you.

CONSUMER GOODS AND CONSUMER DEBT, WITH ITS HIGH INTEREST CHARGES, MIGHT EAT UP A LARGE SHARE OF YOUR MONEY. THEY ARE DISCUSSED IN CHAPTER 5. CHAPTER 6 COVERS RISING PRICES OR INFLATION, WHICH SOMETIMES WORKS SO SUBTLY YOU MAY NOT BE AWARE OF HOW IT ERODES YOUR DOLLARS. Personal income taxes also take their bite. To give you a better understanding of what you must report as income, and what deductions you can take, CHAPTER 7 TELLS HOW OUR FEDERAL GOVERNMENT TAXES PERSONAL INCOME.

With skill and persistence, you will be able to minimize your disappearing dollars and learn how to keep more of your income.

PART TWO

HOW MONEY DISAPPEARS

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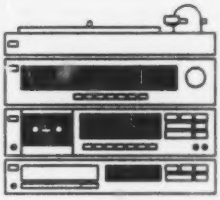
Chapter 5

Consumer Debt

CONSUMABLES AND DECREASING ASSETS



Spending your entire income on consumable items like food, gasoline, and assets that decrease in value over time does not contribute to the goal of financial security. **ASSETS THAT LOSE VALUE CANNOT HELP YOU ACCUMULATE WEALTH.** Look at what you spend or have spent for:

- ✓ Automobiles and automobile accessories
- ✓ Furniture: beds, couches, tables, chairs, dressers, etc.
- ✓ Televisions, sound systems, speakers, VCRs, radios, and telephones
- ✓ Lawn mowers, snow blowers, lawn and garden tools and equipment
- ✓ Saws, drills, and other power tools
- ✓ Computers, including all hardware, software, printers, and supplies
- ✓ Kitchen appliances: toasters, microwaves ovens, food processors, blenders, etc.
- ✓ Recreational vehicles and camping equipment
- ✓ Shoes, clothing, and other personal items

All these items serve an important purpose—they make daily living more convenient and more enjoyable. Goods like computers and power tools make it possible to earn more money in some jobs. Items like stylish clothing and recreational hobbies fulfill certain emotional needs and are important for happiness and self-esteem. **THE FACT REMAINS, HOWEVER, THAT DECREASING ASSETS TAKE A LARGE PERCENTAGE OF INCOME AND WILL NOT ADD TO NET WORTH.** Once used, the item is never worth the amount paid.

SAVINGS BOOK

New clothes, appliances, or the latest software program fulfill short-term needs. Often, your satisfaction with them wanes. Yet, you are left with monthly payments, or an item that is not worth what you paid for it. **IF YOU DO NOT HAVE SAVINGS AND/OR INVESTMENTS, OR A HOME APPRECIATING IN VALUE, YOU HAVE NO WAY FOR YOUR NET WORTH TO GROW.**

Appreciating assets help your net worth to grow

You must also contribute to your long-term needs and put some money into assets that will increase in value as time passes. These include real estate, stocks, bonds, mutual funds, and savings accounts. Over time, they usually grow in value and are worth more than their purchase price.

Consider both your long- and short-term needs. If overspending is a problem, **ALL OF YOUR MONEY CAN DISAPPEAR INTO CONSUMABLE GOODS OR DEPRECIATING ASSETS. TO CHANGE THINGS AROUND, YOU MUST MAKE A CONSCIOUS DECISION TO PUT MONEY ASIDE. A GROWING NET WORTH REQUIRES THAT YOU LEARN TO INVEST A PORTION OF EVERYTHING YOU EARN.**

Every day you buy something you don't need, you also decide not to save

Every day you buy something you don't really need, you also decide not to save. **HOW YOU SPEND YOUR MONEY TODAY DECIDES YOUR NET WORTH TOMORROW.** Only by saving and investing regularly do you give money the opportunity to work for you.

Some people feel they have little control over their present circumstances, so they do not give thought to how they can improve their position. **WE CONSTANTLY CREATE OUR TOMORROWS THROUGH SEEMINGLY MINOR MATTERS THAT TAKE PLACE EVERY DAY.** These "minor matters," such as whether we spend or save, make a big difference over time.

Saving and investing money takes deliberate action based on caring about the future. **DON'T LET DEPRECIATING ASSETS TAKE AWAY FROM YOUR FINANCIAL SECURITY. MAKE SURE YOU ALSO HAVE ASSETS WORKING FOR YOU.**

CREDIT ABUSE ROBS YOUR SAVINGS

DEBT The overuse of credit prevents many people from having extra money. This usually means any debt beyond long-term mortgages and auto loans. Credit cards make it easy to buy now without spending this week's cash. Because many companies encourage consumers to use credit, many people live beyond their means, never realizing that they continually spend more than they earn.

This month's paycheck may be completely spoken for by monthly bills, so any recreational pursuits or unexpected events must be financed with credit. Credit makes it possible to repair

Finance charges rob your savings

the car, buy gifts, and buy new clothes without directly spending your regular monthly income. **INSTEAD OF GIVING UP ONE EXPENDITURE FOR ANOTHER, CREDIT MAKES IT POSSIBLE TO HAVE IT ALL NOW.**

Using credit cards has no ill consequences when you pay them off monthly. **THE HIGH INTEREST CHARGES ON INSTALLMENT DEBT, HOWEVER, TURN POTENTIAL SAVINGS DOLLARS INTO HEALTHY PROFITS FOR THE LENDING INSTITUTION.** In contrast, this is money that could be growing in your savings account instead. Few people realize how long it takes to pay off installment debt once the bills start arriving. Charging is so easy.

Tony and Lisa's Story

Tony and Lisa just purchased a new home. As new homeowners, they didn't plan for the extra money needed for moving expenses and furnishing the house. They bought new furniture on credit because they couldn't afford to pay cash and also pay the required closing costs. Interestingly, after closing escrow on their home, two banks mailed them new credit cards.

A vacuum, lawnmower, and garbage cans were all "necessities" not planned for. Neither were the lamps, light bulbs, and additional telephones. Their old towels and sheets looked out of place in the new home, so they purchased new ones. To buy all these items, they used their new Mastercard and Visa.

Although they intended to pay off their debt quickly, when the monthly bills came in, they could only afford the minimum payment. They then had difficulty coming up with cash to maintain their cars and to buy gas, so they applied for a gasoline company card. Although they tried not to charge, since cash was short, they couldn't avoid some new purchases. Around Christmas, they had no money to buy gifts and their two credit cards were at maximum, so they mailed in an offer to get Visa #2. They charged over $2,000 in December on this new card. Over the next twelve months, they were able to make the minimum monthly payments on all their accounts, but had little success in reducing their debt. The following tables show the details of their installment debt during the third year after they started charging.

Mastercard
Credit Limit: $3,100
APR: 19.8%

	Monthly Payment	New Purchases	Finance Charge	New Balance
Jan.	85.00	158.00	47.89	2,924.84
Feb.	88.00	47.81	47.65	2,932.33
Mar.	88.00	0.00	47.44	2,891.77
April	87.00	127.74	47.99	2,980.50
May	90.00	0.00	48.26	2,938.76
June	89.00	18.00	47.65	2,915.41
July	88.00	0.00	47.96	3,103.70
Aug.	98.00	0.00	51.21	3,061.91
Sept.	92.00	0.00	50.52	3,020.43
Oct.	92.00	0.00	49.84	2,978.27
Nov.	88.00	0.00	49.14	2,939.41
Dec.	87.00	0.00	48.50	2,900.91
TOTALS	1,067.00	351.55	584.05	

TOTAL DEBT REDUCTION: $23.93

Visa #1
Credit Limit: $2,000
APR: 19.8%

	Monthly Payment	New Purchases	Finance Charge	New Balance
Jan.	57.00	0.00	30.75	1,872.82
Feb.	57.00	133.36	30.77	1,979.95
Mar.	60.00	0.00	32.03	1,951.98
April	59.00	0.00	31.58	1,897.73
May	58.00	0.00	31.17	1,889.51
June	57.00	18.00	30.78	1,889.51
July	57.00	0.00	30.34	1,862.85
Aug.	56.00	29.95	30.20	1,867.00
Sept.	57.00	0.00	36.06	1,903.06
Oct.	57.00	0.00	29.81	1,818.87
Nov.	54.56	0.00	30.01	1,794.32
Dec.	53.83	0.00	29.60	1,770.09
TOTALS	683.39	181.31	373.10	

TOTAL DEBT REDUCTION: $102.73

Visa #2
Credit Limit: $2,500
APR: 16.9%

	Monthly Payment	New Purchases	Finance Charge	New Balance
Jan.	79.50	0.00	31.61	2,163.37
Feb.	64.00	204.00	30.88	2,334.25
Mar.	70.00	0.00	32.28	2,296.53
April	68.00	135.80	33.25	2,397.58
May	71.00	0.00	33.14	2,359.72
June	70.00	0.00	32.69	2,322.41
July	93.50	100.00	36.30	2,299.71
Aug.	68.00	37.18	32.30	2,336.58
Sept.	68.00	0.00	35.39	2,336.58
Oct.	68.00	0.00	31.25	2,217.83
Nov.	66.54	0.00	31.27	2,182.56
Dec.	65.48	0.00	30.77	2,178.62
TOTALS	852.02	476.98	391.13	

TOTAL DEBT REDUCTION: $15.25

Furniture
Credit Limit: $6,000
APR: 21.9%

	Monthly Payment	New Purchases	Finance Charge	New Balance
Jan.	123.61	0.00	101.83	5,558.02
Feb.	123.61	0.00	101.43	5,535.84
Mar.	123.61	0.00	101.03	5,513.26
April	123.61	0.00	100.62	5,490.27
May	123.61	0.00	100.20	5,466.86
June	123.61	0.00	99.77	5,443.02
July	123.61	0.00	99.34	5,418.74
Aug.	123.61	0.00	98.89	5,394.03
Sept.	123.61	0.00	98.44	5,368.86
Oct.	123.61	0.00	97.98	5,343.23
Nov.	123.61	0.00	97.51	5,317.13
Dec.	123.61	0.00	97.04	5,290.56
TOTALS	1,483.32	0.00	1,194.08	

TOTAL DEBT REDUCTION: $267.46

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Gasoline Credit Card
APR: 21.00%

	Monthly Payment	New Purchases	Finance Charge	New Balance
Jan.	45.21	91.89	4.10	300.04
Feb.	95.70	36.19	5.34	245.87
Mar.	95.70	36.04	4.32	190.53
April	45.72	68.10	3.33	216.24
May	51.89	12.00	3.78	180.13
June	43.23	82.00	3.15	222.05
July	30.01	0.00	3.88	195.92
Aug.	99.33	0.00	3.21	93.38
Sept.	23.21	79.97	1.51	151.65
Oct.	120.00	211.99	2.43	246.07
Nov.	95.00	61.33	4.26	216.66
Dec.	52.00	26.12	3.79	194.57
TOTALS	797.00	705.63	43.10	

TOTAL DEBT REDUCTION: $105.47

Tony and Lisa started the year with $12,819 of installment debt on their five accounts. During the year they made $4,883 in payments, or an average monthly payment of $407. After making all these payments, their debt was still $12,335—only $484 less! Finance charges were $2,586. New purchases totaled $1,715, including $705 for gasoline. Sadly enough, their total debt reduction for the year was only slightly more than one month's payment.

If Tony and Lisa succeed in making no new purchases and continue making the minimum payment, it will take them approximately five years to pay off their Visas and Mastercard. The furniture, purchased through a finance company working with the furniture store, will take ten years to pay off.

Tony and Lisa's problem is that they don't have the extra money to make more than minimum payments on their installment debt. To correct their unfortunate situation, they must find ways to get the extra money to make higher payments and pay down the principal. **TO MAKE HIGHER PAYMENTS, THEY NEED TO CUT EXPENSES AND/OR BRING IN NEW MONEY.**

GETTING OUT OF DEBT

If you can't see your way out of debt and work out a plan on your own, consumer credit counselors, affiliated with the National Foundation for Consumer Credit, are available in most cities. They will help work out a plan, often at no cost, for those who are overextended but have enough money coming in to make their payments. For those who are seriously overextended, they usually ask the creditors to accept smaller payments, then take the money from their client and pay it to the creditors. For this service they charge a nominal fee. If you go in for credit counseling, be aware of credit clinics in business to make a profit. They could charge a large fee that increases your debt.[2]

Before going in for credit counseling, do all within your power to correct the debt problem on your own. Try bringing in more income by working overtime or earning extra money from a second job. Cut down on expenses. Most importantly: **STOP CHARGING.**

High interest charges (often 16% - 24%) make it difficult to pay off the balance if you only make the minimum payment. If you have no extra money because of charge card payments, use one or more of the following suggestions to get out of debt.

To get ahead, interest needs to work for you, not add to your monthly payments

Make No New
Credit Card
Purchases

MAKE NO NEW CREDIT CARD PURCHASES. Stop charging for perishable items such as clothing, gas, lawn furniture, and household equipment. If you don't have the cash, do without. It is too easy to make only the minimum payment, keep buying, and never get the balance paid off. **THINKING YOU WILL HAVE MORE MONEY TOMORROW IS SELDOM TRUE UNLESS YOU TAKE REALISTIC STEPS TO MAKE IT HAPPEN TODAY.**

Take Out A
Bank Loan

TAKE OUT A BANK LOAN. See if you qualify for a lower interest bill consolidation loan through a bank or credit union. By reducing the interest charges and the monthly payment, you can pay off the debt faster. **IF YOU DO THIS, TAKE THE HIGHEST MONTHLY PAYMENT AND THE SHORTEST TIME PERIOD YOU CAN AFFORD.**

For Tony and Lisa, such a consolidation loan through a bank or credit union would reduce their high interest charges from the 19% range to 9%. For example, a loan for $13,000 at 9% inter-

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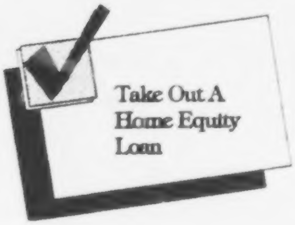
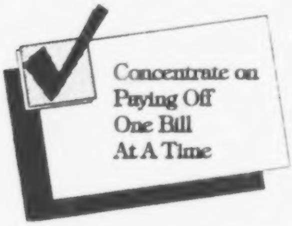
est for 3 years would have payments of $413 per month. With this new loan, they could pay off all their debt in three years.



TAKE OUT A HOME EQUITY LOAN. Homeowners who have equity can turn around a difficult situation by borrowing against their equity. Interest rates for a home equity loan will be lower than those charged by credit card companies. The payments will be lower and the interest will be tax deductible. Just remember, your home is the bank's collateral for the loan and they will repossess it if you don't make the promised payments.

In Tony and Lisa's case, if they qualified for a home equity loan of $13,000 at 9% interest with payments for 15 years, their monthly payment would be approximately $132. They could then make double or triple payments to pay off their loan in less time, or they could start saving $278 per month (the difference between their old and new payment).



CONCENTRATE ON PAYING OFF ONE BILL AT A TIME. If you do not qualify for a home equity loan or a bill consolidation loan, you must reduce the debt with your own systematic plan. To start, select your largest payment, or your most burdensome payment, or the one with the highest interest charges. If possible, double your payments on this bill, so you can pay down the balance and, in doing so, reduce your finance charges.

For example, Tony and Lisa feel their furniture bill with an APR (annual percentage rate) of 21.9% is their worst debt. If they decided to cut back in other areas and pay $250 each month toward this bill, the extra payment would reduce their balance owed at the end of the year from $5,290.56 to $3,611.09. This is a difference of $1,678.58. The additional $126.39 each month would be applied toward the principal, and a lower principal reduces the finance charges. If they had paid $250 per month from the beginning, they could pay off this loan in 32 months instead of 120 months (10 years). Over the life of the loan, they would save $6,858 in finance charges.

Compare the following table with the one shown on page 49 to see how the higher payment reduces the balance owed.

Furniture
Credit Limit: $6,000
APR: 21.9%

	Monthly Payment	New Purchases	Finance Charge	New Balance
Jan.	250.00	0.00	101.83	5,431.63
Feb.	250.00	0.00	99.12	5,280.75
Mar.	250.00	0.00	96.37	5,127.12
April	250.00	0.00	93.57	4,970.69
May	250.00	0.00	90.72	4,811.41
June	250.00	0.00	87.81	4,649.22
July	250.00	0.00	84.85	4,484.07
Aug.	250.00	0.00	81.83	4,315.90
Sept.	250.00	0.00	78.77	4,144.67
Oct.	250.00	0.00	75.64	3,970.31
Nov.	250.00	0.00	72.46	3,792.77
Dec.	250.00	0.00	69.22	3,611.98
TOTALS	3,000.00	0.00	1,032.19	

TOTAL DEBT REDUCTION: $1,819.65

To calculate finance charges, take the annual interest rate and divide it by 12. On Tony and Lisa's furniture loan, the APR was 21.9%. When divided by 12 the monthly charge is .01825 (.219 ÷ 12 = .01825). If the prior month's balance is $3,611.98, the next month's finance charge will be $65.92 ($3,611.98 x .01825 = $65.92).

Begin Sending Money To A Savings Or Investment Fund

ONCE YOU PAY OFF YOUR BILLS, KEEP MAKING PAYMENTS–BUT SEND THE MONEY TO YOUR SAVINGS OR INVESTMENT FUND. To increase your net worth and get money working for you, you must spend less than you earn.

idea

To take control of your finances, acquire the habit of paying cash for all consumable goods and depreciating assets. **IT IS SMART TO GET INTO A 'CASH' HABIT.** To help establish this habit, choose something you want to purchase but can't afford right now, perhaps a needed electronic appliance, an article of clothing, or a small trip or vacation. Work out on paper what you must put away during a six month period to purchase what you want. Take the total needed and divide by 6 (months) or 24 (weeks) to know what you need to save each month or week. For example, if you save $10 a week, you'll have $240 plus a small amount of interest at the end of six months.

Acquire the habit of paying cash

Why go through this exercise when you could more easily go to the store, use your charge card, and not have to wait? Because if you don't pay finance charges and if you earn some interest while saving to purchase, you will have more money working for you. Most importantly, you start a habit of saving. You also gain discipline in money management. When you pay cash, you often spend less because your hard-earned dollars are spent today instead of a credit payment next month.

Turn finance charges into a savings account

Chapter 6

Inflation, the Subtle Saboteur

RISING PRICES

INFLATION MEANS RISING PRICES. This chapter explains why prices keep going up. Inflation started after the Great Depression of the 1930s when the federal government implemented policies to create jobs and stimulate the economy, and it has been with us ever since.

Inflation is a subtle saboteur—at least this has been true since 1939. Each year it steals some of your money. **THE FIRST YEAR YOU MAY NOT NOTICE, BUT A FEW YEARS DOWN THE ROAD, YOUR DOLLARS HAVE DISAPPEARED. INFLATION CUTS AWAY AT YOUR PURCHASING POWER, SO EACH YEAR YOUR DOLLAR BUYS LESS.**

In 1962:

- ➜ A first class postage stamp sold for $.04
- ➜ A gallon of gasoline sold for $.31
- ➜ The maximum social security tax had risen to $150
- ➜ The average price for a new home was $19,300 with a 6% mortgage rate

People were just starting to complain about the high cost of living. Their concerns were well founded, because prices had risen steadily by 2% - 3% each year since World War II.

During the next seventeen years, prices rose an average of 7.15% a year. **By 1979:**

- ➜ The first class postage stamp sold for $.15
- ➜ A gallon of gasoline sold for $.79
- ➜ The maximum social security tax had risen to $1,404
- ➜ New homes averaged $68,300 with mortgage rates between 11%-12%.[3]

In 1979, 1980, and 1981 the United States experienced double-digit inflation with annual price increases of 11.3%, 13.5%, and 13.9% respectively. Rising prices, or inflation, became a national concern. The Reagan administration tried to solve the inflation crisis with their "Program For Economic Recovery." This administration gave Americans some relief from inflation, but initiated no meaningful solutions. The inflation rate eventually dropped to under 4%, but the federal deficit continued to grow.[4] As you will learn, fighting inflation with more debt is like eating chocolate to lose weight. The two are not compatible.

Fighting inflation with more debt is like eating chocolate to lose weight. The two are not compatible

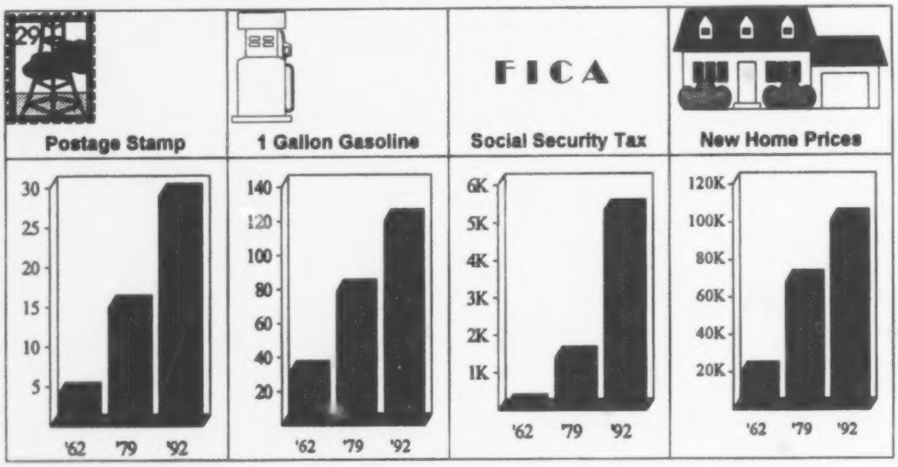
By 1992, Americans had experienced a decade of low inflation (under 4%). Nevertheless, by 1992:

- ➜ The postage stamp sold for $.29
- ➜ A gallon of gasoline was $1.20
- ➜ The maximum social security tax, which now includes social security and Medicare, had risen to $5,329
- ➜ New homes averaged $100,900 with mortgage rates around 8.5%[5]

Steady price increases erode personal income

AS YOU CAN SEE, EVEN WHEN THE INFLATION RATE IS LOW, PRICES RISE SUBSTANTIALLY OVER SEVERAL YEARS. These subtle increases erode personal income. In fact, inflation will ruin the best thought-out financial plan if its long-term influences are not considered.

Table 6.1 THIRTY YEARS OF INFLATION: PRICE INCREASES FROM 1962 TO 1992

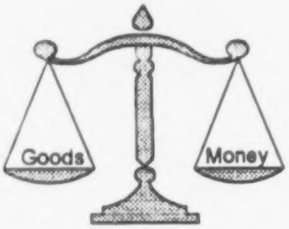


WHAT CAUSES INFLATION?

Inflation is rising prices due to increased spending. The value of all goods and services produced by a nation are referred to as the gross national product or GNP. Economists use the GNP to measure a nation's economic health. **WHEN PRICES RISE, BUT OUR PRODUCTION OF GOODS AND SERVICES (GNP) DOES NOT, INFLATION RESULTS.**

GNP = Goods & Services

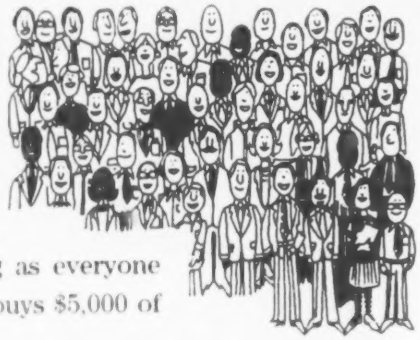
Small price increases (such as 2.5%) are considered normal for a growing economy. Moreover, when prices go up 4%, but you also receive a 4% salary increase, your purchasing power remains the same. **NO NOTICEABLE CHANGE TAKES PLACE AS LONG AS RISING INCOMES BALANCE WITH PRICE INCREASES.**



Usually, when spending and production are out of balance, inflation follows.

For example:

Assume all the people in a small, remote town must attend a weekly auction to buy their groceries. The town provides each of the 100 households $50 to spend each week at the auction. The groceries are auctioned until gone. When 100 people attend and everyone spends their allotted $50, they spend a total of $5,000. This $5,000 is exactly the value of the available groceries. As long as everyone shows up with their $50, the $5,000 of available money buys $5,000 of available goods and everything stays in balance.



If ten households do not come to the auction (a rarity), $500 less (or $4,500) will purchase the $5,000 of groceries. Those who do show up will get more for their money. On the other hand, if the town gives an extra $10 to each of the households, collectively they now have $6,000 to spend. If the available goods do not increase proportionately, the town's people pay more for the same groceries, their dollar loses value, and they experience inflation.

If the people attending the auction could increase their purchasing power through a line of credit at the bank, it would have the same effect. **ANYTIME MORE MONEY BUYS THE SAME SUPPLY, THE PRICE GOES UP. CONSEQUENTLY, THE DOLLAR LOSES PURCHASING POWER. THE SAME LOAF OF BREAD THAT COST 89¢ YESTERDAY COSTS 99¢ TODAY.**

HOW THE FEDERAL GOVERNMENT STABILIZES THE ECONOMY

The 1930 Depression

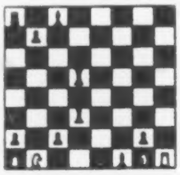
Many seniors today remember the hard times of the early 1930s that started with the stock market crash in October of 1929. Following the crash, people feared losing their savings at the banks, so they showed up en masse to withdraw their money. **BECAUSE SO MANY PEOPLE SHOWED UP AT THE SAME TIME TO MAKE TOTAL WITHDRAWALS, THE BANKS COULD NOT MEET THE DEMAND.** The lucky ones managed to retrieve some of their savings, while the unlucky lost out completely.

Bank failures followed the stock market crash of 1929

ALONG WITH BANK FAILURES, PRODUCTION WAS DOWN EVERYWHERE. Auto production declined 65%, residential construction declined 95%, and the steel industry was down over 80%.[6] **MANY BUSINESSES FAILED BECAUSE PEOPLE JUST DIDN'T HAVE THE MONEY TO BUY GOODS.** Banks gave very few new loans because the job market was so unstable. **ESPECIALLY IN THE CITIES, PEOPLE SUFFERED FROM MASSIVE UNEMPLOYMENT AND HAD NO WELFARE OR UNEMPLOYMENT INSURANCE TO HELP THEM SURVIVE.** Nearly two million people were forced to live on the streets. The fortunate ones, those who had jobs, saw their wages reduced.

- ✓ **Production was down**
- ✓ **Businesses failed**
- ✓ **Massive unemployment was everywhere**

Unlike other depressions before it, this one did not correct itself. Thus, it lasted longer and was more severe. An economist by the name of John Maynard Keynes said **BEFORE CONDITIONS WOULD IMPROVE SOMEONE HAD TO SPEND MONEY TO GET THE ECONOMY MOVING AGAIN. HE SAID IF THE GOVERNMENT CREATED JOBS, IT WOULD GIVE PEOPLE MONEY.** With money, they would start buying; the renewed consumer spending would help businesses. **SO, WHEN OTHER PLANS FINALLY FAILED, THE GOVERNMENT DID STEP IN AND START SPENDING TO CREATE JOBS. IT WORKED JUST LIKE KEYNES PREDICTED.**[7]


STALEMATE

The government started spending to create jobs. This put money back into the economy

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The Role of Government Has Changed Since the Depression

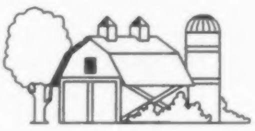
Employment and Government Contracts

Since its major involvement bringing the country out the Great Depression, the federal government's role changed. For instance, in 1929 the federal government employed less that 2% of the workforce, but today it employs, directly or indirectly, more than 25% of the total workforce.[8] Government workers receive steady wages that can help offset other depressed markets. **THIS LARGE PERCENTAGE OF 'GUARANTEED' EMPLOYMENT HELPS KEEP SOME MONEY CIRCULATING.**

SALES CONTRACT

Along with being a major employer, the federal government is also a primary purchaser of goods. The government buys airplanes, missiles, machinery, and office equipment. **MANY BUSINESSES DEPEND ON GOVERNMENT CONTRACTS TO KEEP THEM GOING.** Government expenditures for goods and services totaled $9 billion in 1929, compared to an estimated $1,518.6 billion in 1995.

Payments to Individuals



THE GOVERNMENT ALSO REDISTRIBUTES MONEY TO INDIVIDUALS. These payments include social security, veteran's pensions, welfare, and subsidies to farmers. These payments increased from 3.7 billion in 1929 to approximately 627 billion by 1993.

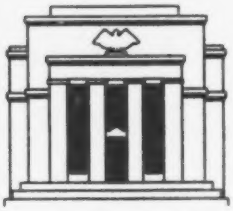
FDIC Insurance

Another major change since the Great Depression is the creation of the Federal Deposit Insurance Corporation (FDIC) to guarantee individual bank accounts. This guarantee prevents another panic like the one in 1929 when millions of people tried to withdraw their funds at the same time. **ACCOUNTS AT FDIC INSURED BANKS GIVE PEOPLE SECURITY DURING BAD TIMES.** People know their savings are backed by the federal government, so they do not rush out to withdraw their funds even when bank reserves are low.

FDIC

Money Supply

"Like an engine that runs on gasoline, the economy runs on money."[9] The Federal Reserve Board has the specific duty of monitoring the money supply. They accomplish this by deciding how much money will pass through the banking system. When they require commercial banks to keep a large percentage of their money in reserve, the banks must hold back more



funds and therefore have less money available to loan to businesses, farmers, and individuals. **FEWER LOANS RESULT IN BUSINESSES CUTTING BACK AND LAYING OFF THEIR EMPLOYEES, LESS MONEY CIRCULATING, AND RISING INTEREST RATES.** On the other hand, when the Federal Reserve lowers the reserve requirements, the banks have more money to loan. **THIS INCREASED LENDING LEADS TO BUSINESS EXPANSION, MORE MONEY IN CIRCULATION, LOWER INTEREST RATES, AND REDUCED UNEMPLOYMENT.**

THE FEDERAL RESERVE CONTROLS THE MONEY SUPPLY

HIGH BANK RESERVES	**LOW BANK RESERVES**
Tight Money	***Easy Money***
Less Money To Loan	More Money To Loan
Higher Interest Rates	Lower Interest Rates
Fewer Loans	More Loans
Little Business Expansion	Business Expansion
Less Jobs	More Jobs

BY CONTROLLING THE MONEY SUPPLY, THE FEDERAL RESERVE BOARD INDIRECTLY INFLUENCES BUSINESS EXPANSION. "Easy money" encourages business expansion and creates jobs to help solve high unemployment. "Tight money" reduces available credit and holds the reins on inflationary pressures.

THE FEDERAL GOVERNMENT STABILIZES THE ECONOMY THROUGH:

- ✓ Direct employment
- ✓ Indirect employment through government contracts
- ✓ Payments to individuals
- ✓ Bank account guarantees
- ✓ Control of the money supply

Deficit Spending

Increased government control protects us from the ill effects of another great depression, but requires huge expenditures. These expenses exceed federal revenues. **INSUFFICIENT INCOME TO MEET NEEDED EXPENSES HAS CREATED A HUGE NATIONAL DEBT.**

THE TERM 'DEFICIT SPENDING' COMES FROM USING CREDIT (DEBT) AS A SOURCE FOR ADDITIONAL FUNDS. The difference between what the government takes in and what it spends is the federal deficit. Primarily, federal revenues come from taxes that individuals and businesses pay, such as individual and corporate income taxes, employment, estate, gift, and excise taxes.

The money collected then goes out to support the military, the disaster relief fund, our judicial system, housing, social security, agricultural programs, government research, the space program, wages for government employees, services for the poor, services for the elderly, and other programs. **WHEN THE GOVERNMENT'S COST FOR THESE ITEMS IS HIGHER THAN THE AMOUNT OF MONEY THEY COLLECTED, DEFICIT SPENDING RESULTS.**

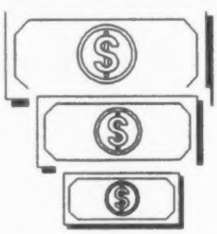
EXPANDED GOVERNMENT SUPPORT OF MANY PUBLIC PROGRAMS INCREASES GOVERNMENT SPENDING. Such financing has created an enormous national debt that will be difficult to correct. As the debt increases, so do the interest payments, adding to the tax burden of all citizens. If the debt were divided equally among all citizens, we each would owe $16,000. For fiscal 1993, the public debt was $4,351.2 billion; the interest charges alone were over $292 billion. Table 6.2 shows how the total national debt has increased since 1960.[10]

Table 6.2 NATIONAL DEBT

	National Debt
1960	$ 284.1 billion
1970	$ 370.1 billion
1980	$ 907.7 billion
1990	$3,233.3 billion

INFLATION

The Shrinking Dollar



Dependence on government controls makes our economy vulnerable to inflation. **MORE MONEY PUT INTO CIRCULATION WITH NO OFFSETTING INCREASE IN PRODUCTIVITY DILUTES THE VALUE OF THE DOLLAR.** Inflation results.

My neighbor told me that when he cooked dinner, friends and relatives often stopped by just before the meal was ready. So, he started grating potatoes into the ground meat to stretch it to feed more people. Using this as an example, deficit spending affects the dollar in the same way the potatoes affect the meat. Both dilute the end product, reducing the quality through increasing the quantity.

ANOTHER WAY TO LOOK AT INFLATION IS THROUGH THE DOLLAR'S LOSS OF PURCHASING POWER. The same dollar buys less. Perhaps you've seen advertisements in old magazines selling a cup of coffee for a dime, a candy bar for a nickel, a steak dinner for $.99, or even a gallon of gasoline for $.21. No doubt, you know what these items cost today.

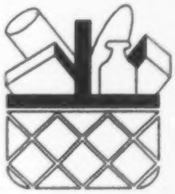
Ad From Life Magazine, **1955**
Vol. 39, No. 21

"How I Retired
In 15 Years With
$250 A Month"

Ad From Life Magazine, **1966**
Vol. 60, No. 3

"How I Retired
In 15 Years With
$350 A Month"

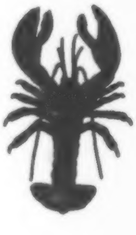
CONSUMER PRICE INDEX



THE CONSUMER PRICE INDEX (CPI) MEASURES THE ANNUAL INFLATION RATE. The U.S. Bureau of Labor Statistics publishes this index monthly. They track costs of household items used throughout our country, then compile the data to show price trends. The CPI is based on the average cost of over 400 items categorized as: food, shelter, rent, fuel and utilities, apparel and upkeep, transportation, medical care, entertainment, and commodities.

In 1967, the CPI was arbitrarily set at 100 for ease in measuring future increases. **THE MONTHLY OR ANNUAL CPI INCREASE IS THE SAME AS THE INFLATION RATE.** For example, the CPI rose from 100 in 1967 to 104.2 in 1968. Purchases, based on average costs, that were $100 in 1967, rose to $104.20 in 1968. The percentage increase of 4.2% was the inflation rate for that year.

Goods = $100 in 1993
Goods = $104 in 1994
This is a 4% increase
Inflation Rate = 4%



KEEP IN MIND THAT COST-OF-LIVING INCREASES ARE AVERAGES, AND AVERAGES CAN BE MISLEADING. Prices for different items vary from one section of the country to another. For instance, housing is more expensive in California and Hawaii. Oranges are cheaper in Florida than Alaska, while a cord of wood is cheaper in Vermont than Nevada. Lobster is cheaper in Maine than Chicago. Along with these regional differences, families seldom make the same purchases or use the same services. Some may need to buy a new car, others a new washing machine, and still others require no major purchases. Translated into real dollars, with the current CPI at 258.0 it now takes $258.00 to purchase what $100 bought in 1967.[11]

Table 6.3 ANNUAL INCREASES IN THE CONSUMER PRICE INDEX

YEAR	CPI INDEX	INCREASE
(Base) 1967	100.0	———
1968	104.2	4.2%
1969	109.7	5.3%
1970	115.4	5.9%
1971	119.7	4.3%
1972	123.0	3.3%
1973	129.2	6.2%
1974	140.2	11.0%
1975	149.3	9.1%
1976	155.1	5.8%
1977	161.6	6.5%
1978	169.3	7.7%
1979	180.6	11.3%
1980	194.1	13.5%
1981	204.1	10.4%
1982	210.6	6.1%
1983	213.8	3.2%
1984	218.1	4.3%
1985	221.7	3.6%
1986	223.6	1.9%
1987	227.2	3.6%
1988	231.3	4.1%
1989	236.1	4.8%
1990	241.5	5.4%
1991	245.7	4.2%
1992	248.7	2.9%
1993	251.7	2.8% est.
1994	254.8	3.8% est.
1995	258.0	3.2% est.
	Average =	**5.64%**

If you look closely at Table 6.3, you will see why inflation was such a major concern from 1973 through 1981. Prices increased a total of 81.5% during those nine years, or an average of 9.05% per year. Fortunately, between 1984 and 1995 the inflation rate remained low, averaging only 4%. Will it stay that low? Probably not, since its history has shown rising and falling rates.

THE AVERAGE INFLATION RATE SINCE 1967 HAS BEEN 5.64%. With 6% inflation, prices double every twelve years. It is scary to think of 12% inflation because then prices double every six years (remember the Rule of 72). Sometimes these increases cause national concern as they did during the late 1970s and early 1980s, while other times increases are so slight we hardly notice them. **IN BOTH CASES, THE COMPOUNDED, LONG-TERM EFFECT ERODES THE BUYING POWER OF YOUR DOLLAR.**

WHY INFLATION WON'T END

Inflation is here to stay. **WE CAN'T STOP IT; WE CAN ONLY SLOW IT DOWN.** Inflation compounds just like interest, with each annual increase becoming the starting point for next year's escalation. If the inflation rate is a constant 6%, prices will double every twelve years.

Stopping inflation is almost impossible. It would require large cutbacks in government spending and again leave us with a volatile economy, subject to dramatic ups and downs. The cures for inflation, at this point, seem worse than the consequences. The following factors make it a certainty that inflation will continue:

INDEXING ADJUSTS PAYMENTS TO THE CONSUMER PRICE INDEX

PEOPLE DEMAND INDEXING WHEN THEY NOTICE INFLATION AS A PROBLEM. Indexing occurs when a payment increases annually, the same percentage as the Consumer Price Index. Social security payments are one example of indexing. If the Consumer Price Index rises by 4%, social security payments will be 4% higher.

Once indexing starts, it becomes part of the economy and doesn't stop. A cycle then begins, with one end feeding on the other. Workers ask for higher salaries to keep up with the Consumer Price Index, but higher salaries help contribute to the Consumer Price Index rising. The companies they work for charge more for the goods they produce to fund the higher wages. We now have indexing for some wages, social security payments, personal income taxes, and many other items. Higher prices are commonplace; lower prices are rare.[12]

SOCIAL SECURITY PAYMENTS CONTINUE TO RISE

MANY AMERICANS HAVE MISUNDERSTOOD THE PURPOSE OF SOCIAL SECURITY. Although Congress designed the system to be a supplemental, not a primary source of income, many people retiring today depend on social security payments to meet their necessary living expenses. More people must learn not to depend on social security. When the 80 million baby boomers (those born between 1943 and 1964) retire, the social security system will have more dependent retirees than contributing workers for the first time in our history.

People age sixty-five and older increased in number from 4% of the total population in 1900 to 12% of the total population by 1990. The numbers will grow even more dramatically as the baby boomers age.[13] These increasing numbers, combined with decreasing mortality rates, mean more payments to more people for longer time periods. More payments and more recipients translate into even higher employment taxes, a reduction of benefits, or both.

Retirement

TAXPAYERS WILL PAY FOR THE FAILED THRIFT INSTITUTIONS

FSLIC

Expenses for taxpayers increased with the government bailout of thousands of failed savings and loans. Between 1981 and 1991, 1,345 thrift institutions failed.[14] The savers' funds were guaranteed by the federal government through FSLIC insurance. As it turns out, most of the assets that the S & L's were supposed to have to back up the savings accounts was in over-appraised real estate. Therefore, the government had to return the "misused" funds to the savers. Since 1989, the government has paid out an average of $9,000 on the 22 million insured accounts. The total cost to taxpayers over the next thirty years will be over $150 billion.[15] **TAXPAYERS PAY OUT MORE, BUT GET NOTHING IN RETURN.** This additional cost adds to inflation.

CUTBACKS IN SPENDING MAKE POLITICIANS UNPOPULAR

Politicians need public support to get reelected. Their backing often comes from campaign platforms that lead to even more government spending. Again, more spending translates into higher taxes and an increased federal deficit.

VOTE
BALLOT BOX

Can you imagine a politician getting elected into office by saying they would:

- Increase taxes
- Allow banks to fail and let people lose their money
- Allow corporations to go under without offering government assistance, leaving thousands of workers unemployed
- Provide no compensation for the needy
- Decrease social security payments
- Increase the employer and employee social security taxes AGAIN
- Raise interest rates to discourage borrowing
- Abolish Medicare and Medicaid
- Stop providing funds to improve interstate highways
- Freeze wages for all government workers and freeze pensions for all government retirees
- Freeze military spending

IN THEORY, WE READILY AGREE TO CUT BACK ON GOVERNMENT SERVICES—UNTIL IT AFFECTS US PERSONALLY. BECAUSE POLITICIANS NEED TO BE POPULAR, NO ELECTED OFFICIAL WOULD STAY IN OFFICE BY SUPPORTING EMPLOYMENT CUTBACKS AND TAX INCREASES. THAT IS THE MAIN REASON WHY THE GOVERNMENT CAN'T AND WON'T DECREASE SPENDING TO FIGHT INFLATION.

INFLATION IS NOT ALL BAD

CONTINUAL RISES IN THE COST OF LIVING ARE NOT NECESSARILY BAD IF YOUR INCOME AND/OR ASSETS ALSO INCREASE. By understanding inflation and planning to live with it, your wealth need not diminish. Inflation, however, does change many of the old money rules.

INFLATION HURTS THOSE LIVING ON FIXED INCOMES. Retirees living on fixed pensions or landlords receiving a fixed amount of rent will see their dollars diminish in purchasing power each year. If the inflation rate is 6%, a retiree who receives $800 a month this year will receive only $752 of buying power the following year, then $707 the next year on the same $800 a month check. At a steady 6% inflation rate, that $800 of monthly income erodes to $431 of purchasing power after ten years.

Table 6.4 shows how $1,000 decreases in purchasing power in just ten years with inflation rates of 4%, 6%, and 8%.

Table 6.4 DECLINING VALUE OF $1,000

	4% Inflation	6% Inflation	8% Inflation
Year 0	$1,000	$1,000	$1,000
Year 1	$ 960	$ 940	$ 920
Year 2	$ 922	$ 884	$ 846
Year 3	$ 885	$ 831	$ 779
Year 4	$ 849	$ 781	$ 716
Year 5	$ 815	$ 734	$ 659
Year 6	$ 783	$ 690	$ 606
Year 7	$ 751	$ 649	$ 558
Year 8	$ 721	$ 610	$ 513
Year 9	$ 693	$ 573	$ 572
Year 10	$ 665	$ 539	$ 434

SAVERS WHO EARN FIXED INTEREST LOSE WITH INFLATION UNLESS THEIR FIXED INTEREST EARNINGS EXCEED THE INFLATION RATE. The difference between the interest rate and the inflation rate represents the real earnings on an account. Interest at 4% with inflation at 3% gives 1% net earnings **BEFORE TAXES.** After paying income taxes on the interest earnings, the account has lost buying power and, therefore, decreased in value.

IN TIMES OF HIGH INFLATION, DEBTORS WIN AND CREDITORS LOSE. Each year that a debtor pays back a fixed amount on a loan, he is repaying with dollars that have declined in value. In fact, banks now protect themselves from losing much of their profit to inflation through variable rates. Understandably, banks do not want to be left holding thirty-year mortgages that have lower than market yields, so when interest rates go up, their adjustable mortgages go up as well.

Interestingly enough, **SOMETIMES INFLATION CAN HELP TO CREATE WEALTH.** People benefit when their investments increase in value faster than the inflation rate. Those who bought real estate in the right location prospered from the inflation cycle between 1973–1982. Along with all real estate, home values skyrocketed during this period, especially in California. Many homeowners were able to double or triple their equity within 4-8 years.

REAL ESTATE MARKET

An investment that goes up in value as prices rise will protect your dollars from losing buying power. In the past, real estate and stocks have been excellent inflation hedges. The pivotal questions are: Where will real estate values continue to go up? What stocks will increase in value? Will gold, oil, or silver values increase? As the senior citizen population grows, what services and products will expand? Will it be health care facilities, computer technology, or recreational facilities? **THE "WINNERS" WILL MAKE MONEY AND BECOME INFLATION HEDGES FOR THOSE LUCKY OR CLEVER ENOUGH TO INVEST IN THEM.**

An investment that goes up in value as prices rise will protect your dollars from losing buying power

Your challenge is to be on guard against inflation. **DON'T PUT YOURSELF IN THE POSITION OF HAVING ONLY A FIXED INCOME IN AN ECONOMY WHERE PRICES KEEP RISING.** Instead, participate in that economy with investments that increase in value. If your income doesn't grow to match rising price levels, what may seem like a lot of money today can put you on the poverty level tomorrow.

If your income doesn't grow to match rising price levels, what may seem like a lot of money today can put you on the poverty level tomorrow

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Chapter 7

Personal Income Taxes

This is a long chapter with many details. You may want to refer to Mindmap II at the beginning of the book if you need to find specific information quickly.

TAXES
TAXES

IF YOU DO NOT KNOW THE BASIC RULES FOR TAXING PERSONAL INCOME, YOU COULD LOSE 'EXTRA' DOLLARS. This is especially true for the years when you have additional income from investment sales, bonuses, or a business boom. Our tax laws have become so detailed that many citizens just shake their heads and say, "taxes are too complicated." Then, to make matters worse, Congress changes the rules and forms every year. What is true this year is likely to change next year. In spite of the many details and ongoing changes, if you know the general concepts for taxing personal income, you will maintain an advantage that will help you keep more of your dollars. This chapter will show you:

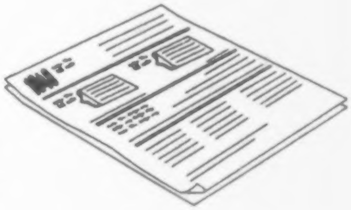
- ✓ What you must report as income and what you can deduct
- ✓ What you can take as deductions from your income
- ✓ The importance of tax planning
- ✓ How to use the tax forms so you can prepare your own taxes or verify the work done by someone else

Need
to
Know

Understandably, you stand to benefit the most by reducing your tax bill. **IF YOU KNOW THE BASICS—WHERE TO GET RELIABLE INFORMATION, WHAT INCOME IS TAXED, AND WHAT DEDUCTIONS THE LAW ALLOWS—YOU HAVE A GOOD CHANCE OF SAVING SOME EXTRA MONEY.**

Knowing the rules for taxing personal income helps you plan tax saving strategies either on your own or with the help of a tax professional.

FREE INFORMATION



It is easy today to be aware of changes in tax law. Many newspapers feature tax saving tips and provide information on current legislation. When you need more information on specific topics, the Internal Revenue Service provides an abundance of it free of charge.

☎ A service called **Tele-Tax** offers taxpayers in every state the opportunity to hear prerecorded tax information over the telephone. Through this service, the IRS provides information on about 140 topics, all available through a toll-free number.

Along with Tele-Tax, the IRS also provides **booklets** giving the current tax law on many subjects. A complete listing of the Tele-Tax topics, the free booklets, and other IRS resources are listed in **Publication 910, Guide to Free Tax Services.** To order it, call: **1 (800) 424-FORM (3676),** or your city's local IRS—it's free.

Take advantage of free information

GENERAL RULES

Who Is Required to File?

AGE, **GROSS INCOME**, and **FILING STATUS** determine if an individual needs to file a tax return. All taxpayers are allowed two deductions:

❶ The PERSONAL EXEMPTION(S) and DEPENDENT(S) deduction(s)

❷ The STANDARD DEDUCTION or ITEMIZED DEDUCTIONS

When a person's taxable income exceeds the standard personal exemption and the standard deduction amounts, he or she must file. For example, in 1995, for a

Your income determines if you need to file

single person under age 65, the personal exemption was $2,500 and the standard deduction was $3,900. When a single person has taxable income above $6,400 ($2,500 + $3,900), he or she needs to send in a tax form. Married couples and senior citizens over age 65 have higher deductions, so they can have more taxable income before they must file.

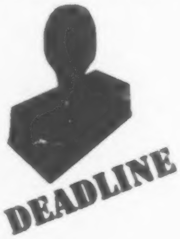
The following people should file a tax return. They are exceptions to the "gross income filing requirement":

- ✓ Self-employed persons with net earnings above $400
- ✓ People who received advanced earned income credit from their employer
- ✓ Those applying for a refund of income tax withheld

Interest and Penalties

When the IRS owes you money on a prior year's return, they pay you interest of 2% above the short-term federal rate. But, they charge you interest of 3% above the short-term federal rate for all taxes not paid on time. In both cases, the interest compounds daily.

WHEN YOU DON'T HAVE THE MONEY TO PAY YOUR TAXES, YOU SHOULD STILL FILE YOUR TAX RETURN. When you file but don't pay, the IRS assesses a penalty of ½% per month on the balance due (to a maximum of 25%) for not paying on time. In addition, the separate penalty for not filing on time is 5% per month of the unpaid tax (to a maximum of 25%). **THE MINIMUM PENALTY FOR NOT FILING IS THE LESSER OF $100 OR 100% OF THE UNPAID TAX.** Besides the late payment penalty and the failure to file penalty, the IRS will charge current interest on the balance due. Penalties plus interest can quickly amount to a substantial bill.



WHEN YOU OWE TAXES AND YOU CAN'T PAY, THE WORST THING TO DO IS TO IGNORE IRS BILLS AND LETTERS. They have the right to freeze your bank accounts, garnish your wages, and put liens on your property. You can save this hassle and embarrassment by communicating with them and working out a payment plan to retire your tax bill.

Withholding and Tax Estimates

FOR TAXPAYERS WHO HAVE INCOME UNDER $150,000, THE TAX LAW REQUIRES INDIVIDUALS TO PAY IN, THROUGH WITHHOLDING OR ESTIMATED PAYMENTS, EITHER 90% OF THE TAX DUE, OR 100% OF THE PREVIOUS YEAR'S TAXES. You will be charged another penalty, *underpayment of estimated tax*, if you don't pay in enough tax during the year. Form W-4 tells your employer how much tax to withhold (deposit on your behalf) from your paycheck. The number of exemptions you claim, along with your filing status (married or single), increases or decreases your withholding taxes. You can modify the amount withheld by amending Form W-4 with your employer.

Form W-4 tells your employer how much to withhold from your pay

Anytime you have a situation that reduces your tax liability, such as financial losses, a new home with higher mortgage interest and property tax write-offs, a new dependent, large charitable contributions, or a reduction in income, you may be able to decrease your withholding tax to give yourself more monthly income.

ALTHOUGH IT IS WISE TO AVOID PENALTIES FOR UNDERWITHHOLDING, IT IS ALSO WISE TO AVOID BANKING WITH THE IRS. They don't pay interest on a current year's refund money. Additionally, you have no access to your money until your refund check arrives. So, when expecting a large refund, adjust your withholding on Form W-4 and put the extra money in savings. This way you have access to your money and its earnings.

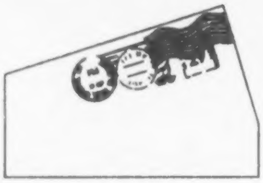
Similarly, if a situation occurs during the year that increases your taxable income, do a tax estimate to see if you are having enough withheld (see Chapter 16, *Planning: Annual Tax Projection*). Higher taxes result from salary increases and bonuses, making a profit on investments, selling real estate or business property at a profit, or losing an exemption or previous deduction.

WHEN YOU EXPECT TO OWE MORE TAX THAN YOU HAVE WITHHELD, MAKE SURE YOU PAY IN ENOUGH TO AVOID THE UNDERWITHHOLDING PENALTIES. Then, put the balance you expect to owe into a money market account or a bank account where it will earn interest until you file your tax return and need the money to pay. Do not make estimated payments beyond the amount required. Doing so gives the government an interest-free loan. Instead, put the interest earnings in your account.

Example:

Burt's prior year tax liability was $6,000. This year Burt made a $20,000 profit on some investments and expects to owe an additional $5,600 in federal tax. As long as Burt pays in $6,000 (100% of the prior year's tax), and pays the additional amount owed ($5,600) by April 15 (the filing deadline), he will incur no penalties. Strategically, Burt should "save" the $5,600 in his own account, and not pay the tax until it is due on April 15. The interest earnings on this money are now his to keep.

Extensions



Erroneously, many people who owe taxes think they can have three more months before they have to pay the tax due if they file an extension. True, **THE IRS ALLOWS AN AUTOMATIC EXTENSION OF THREE MONTHS (FROM APRIL 15 TO AUGUST 15) FOR ALL TAXPAYERS WHO FILE FORM 4868 BY APRIL 15.** If you wait until August 15 to pay, however, the IRS will charge you interest from April 15 on the amount you owe.

ANOTHER TWO MONTH EXTENSION WILL GIVE YOU UNTIL OCTOBER 15 TO FILE YOUR TAXES. This extension, Form 2688, requires IRS approval, so when you need more time, send it in several weeks prior to the August 15 extended deadline. **JUST REMEMBER, THE IRS WILL CHARGE INTEREST FROM APRIL 15 ON ALL MONEY YOU OWE REGARDLESS OF ALLOWED EXTENSIONS.**

Amended Returns

If you neglect to take a deduction or to report income in one year, you cannot make it up by reporting these changes in a subsequent year. Instead, you must amend your return for the year of the error. **REPORT CHANGES MADE TO A PREVIOUSLY FILED TAX RETURN ON FORM 1040X.**

FORM 1040

FORM 1040 IS THE REQUIRED TAX FORM FOR INDIVIDUALS. Since it includes many backup schedules, it is referred to as "the long form." Forms 1040A and 1040EZ are shortened versions of Form 1040. Just remember, the shortened versions do not list all of the permitted deductions, so if you use 1040A or 1040EZ, check the long form periodically to make certain you haven't missed any applicable write-offs.

SINCE THE TWO PAGES OF FORM 1040 SUMMARIZE ALL OF THE OTHER SCHEDULES, THEY CONTAIN A WEALTH OF INFORMATION. Being familiar with this form will help you:

- ✓ Know what income you must report
- ✓ Know what you can subtract from your income
- ✓ Prepare or check your tax return for accuracy
- ✓ Be aware of deductions that may apply on future returns

Get Form 1040 to Look at While Reading this Section

FOR EASE IN GOING THROUGH THE FOLLOWING INFORMATION, GET THE MOST CURRENT YEAR'S FORM 1040, THE LONG FORM. Do not use 1040A or 1040EZ. All libraries have copies, or you could make a copy from a prior year's tax return.

The left margin divides Form 1040 into eight sections. Locate these sections on the tax form. The sections have not changed in years, although changing tax law adds or subtracts line items from these sections.

Get Red, Yellow, Blue, & Green Highlight Pens

Marking Form 1040 with four highlight pens: red, yellow, blue, and green will give you a visual reference. If you highlight the title of each section in this text and/or highlight the actual tax form as you read about it, you will then associate the color with the section. This helps put the information into easy-to-remember categories. **YOUR RIGHT-BRAIN NEEDS A VISUAL REFERENCE.** To begin, highlight what the colors represent:

Income is GREEN

Deductions are YELLOW

Payments and credits are BLUE

Taxes owed are RED

Continue to highlight in this text and on Form 1040 all sections referred to as you read about them.

FORM 1040 HAS EIGHT SECTIONS:

YELLOW	1. **FILING STATUS**	YELLOW & RED	5. **TAX COMPUTATION**
YELLOW	2. **EXEMPTIONS**	BLUE	6. **CREDITS**
GREEN	3. **INCOME**	RED	7. **OTHER TAXES**
YELLOW	4. **ADJUSTMENTS TO INCOME**	BLUE	8. **PAYMENTS**

YELLOW Filing Status

(Locate and highlight this section on Form 1040)

Each filing status has its own tax table or tax rate schedule. Also, each category qualifies for different standard deductions. The four filing categories are:

❶ Married Filing Joint, and Surviving Spouses
❷ Single

❸ Head of Household
❶ Married Filing Separately

EACH FILING STATUS HAS DIFFERENT INCOME LEVELS FOR THE STANDARD TAX RATES. In any year that you experience a major life change, such as the death of a spouse, marriage, divorce, separation, or the addition or deletion of a dependent, your taxes will change. In 1995, the 28% tax rate started at $31,250 for a *Head of Household* and at $23,350 for a *Single*.

All taxpayers start at a 15% tax rate, then as taxable income increases, move up to the 28%, 31%, 36%, and 39.6% rates. **EACH YEAR, THE IRS ADJUSTS THE TAX TABLES FOR INFLATION. THEY INCREASE THE BASE TAXABLE INCOME BY THE INFLATION RATE.** This adjustment is made according to the inflation rate from August 31 of the preceding year to August 31 of the current year. This annual inflation adjustment allows the percentage taken for taxes to stay relatively stable as wages increase to keep up with the cost of living.

Example:

In 1993 the 15% bracket for a single person was $22,100
In 1994 the 15% bracket for a single person was $22,750
In 1995 the 15% bracket for a single person was $23,350

Filing Choices

SINGLES AND HEADS OF HOUSEHOLDS HAVE NO FILING CHOICE, BUT MARRIED COUPLES CAN CHOOSE TO FILE JOINTLY OR SEPARATELY. THE SEPARATE FILING OPTION IS NOT ADVANTAGEOUS, HOWEVER, UNLESS ONE OR BOTH SPOUSES CAN TAKE LARGE EXPENSES THAT WOULD BE DISALLOWED ON A JOINT RETURN. For instance, higher joint income could disallow some deductions that must exceed certain percentages, such as employee business expenses, medical expenses, and casualty and theft losses. Sometimes by filing separately, the individual claiming the lower income may be able to write off deductions that would be lost on a joint return.

Married Couples Can File Jointly or Separately

Married couples who choose to file separately will find that a higher tax rate applies, and once reaching a certain income level, they will lose deductions. Also, if one spouse itemizes instead of electing the standard deduction, the other spouse also must itemize. Furthermore, unless they file jointly, married couples cannot claim the earned income credit, the dependent care credit, the credit for the elderly, or take an IRA deduction for a non-working spouse.

Yellow Your filing status gives you a deduction

YELLOW Exemptions, Personal and Dependent

(Locate and highlight this section on Form 1040)

The second section of Form 1040 covers personal exemptions and the additional exemptions allowed for dependents. **GENERALLY, TAXPAYERS CAN DEDUCT A SET AMOUNT FOR THEMSELVES AND EACH QUALIFYING DEPENDENT.** This amount also changes each year to adjust for inflation.

→ For example, the $2,300 deduction allowed in 1992 rose to $2,350 in 1993, to $2,450 in 1994, and to $2,500 in 1995.

Dependents one year of age or older must have social security numbers. You can claim a child born anytime during the tax year, even if born on December 31st. Also, if a qualifying person you support dies at the beginning of the year, you still claim him or her as a dependent for the entire year.

FIVE TESTS DETERMINE IF YOU CAN CLAIM A PERSON AS A DEPENDENT

① **Support:** You must contribute over one-half of their total support.

② **Member of Household or Relative:** The dependent must be a relative or someone who lives with you full-time (cousins do not count as relatives).

③ **Gross Income:** The dependent's gross income must be less than the exemption amount ($2,500 in 1995). Two exceptions to this test are children under nineteen years of age and students under age twenty-four. You still must meet, however, the other dependency tests.

④ **Joint Return:** If you claim a married, dependent child, he or she cannot file a joint return with his or her spouse unless it is merely to claim a refund of withheld taxes.

⑤ **Citizenship:** Finally, your dependent must be U.S. citizen or national, or a resident of the United States, Canada, or Mexico.

TO CLAIM PARENTS OR OTHER RELATIVES, YOUR SUPPORT MUST EXCEED THEIR TOTAL SUPPORT COSTS. Divorced or separated couples must decide who will claim the children from their marriage. When divorced couples disagree, tax law allows the parent who provides more than half of the child's support to claim the exemption. **GENERALLY, TAX RULES CONSIDER THE PARENT WHO HAS CUSTODY OF THE CHILD FOR THE GREATER PART OF THE YEAR AS THE ONE WHO PROVIDED MORE THAN ONE-HALF OF THE SUPPORT.** The custodial parent can release the exemption to the noncustodial parent by signing a written declaration on IRS Form 8332.

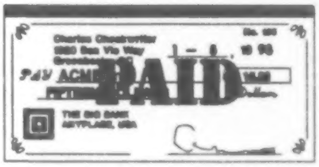
Yellow Personal and dependent exemptions give you a deduction

GREEN

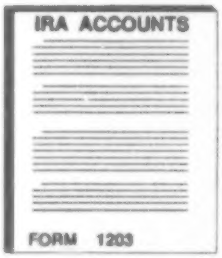
Income

(Locate and highlight this section on Form 1040)

REPORT ALL INCOME IN THIS SECTION. Report the entire amount of pensions along with the taxable portion, even though only the taxable portion will count. Although it is not taxed, you must also report tax exempt interest. It is used to determine taxable social security. The sale of investments, business assets, rental properties, partnerships, and business interests will produce gains or losses. **TOTAL INCOME IS THE RESULT OF ADDING ALL THE POSITIVE AND NEGATIVE NUMBERS. LINES SHOWING NEGATIVE NUMBERS (LOSSES) REDUCE OTHER INCOME DOLLAR FOR DOLLAR.**



IN MOST INSTANCES, IF TAX LAW REQUIRES A TAXPAYER TO REPORT INCOME, ANOTHER PERSON OR BUSINESS TOOK A DEDUCTION FOR THAT SUM. Employers deduct gross wages paid to employees from their profits; employees report these gross wages as income. Banks, corporations, credit unions, mutual fund companies, and others who pay interest and dividends deduct the payments made to shareholders; the recipient counts the payment as income. The spouse who pays alimony writes it off; the spouse who receives the payments counts it as income.



Generally, income is taxed only once. Since contributions to IRAs, pension plans, or tax sheltered annuities are excluded from income and the earnings accumulate "tax free," all money coming out of the account is 100% taxable. When a person takes no deduction for the contribution, but the earnings accumulate "tax free," upon withdrawal, only the interest is taxed. This is the case with nondeductible IRAs and annuities purchased with regular money.

ANNUITIES ARE AN INVESTMENT VEHICLE THAT FUNCTION UNDER SOME SPECIAL IRS RULES. They can be purchased with regular after-tax money, through life insurance, or through some retirement plans. They can only be written through life insurance companies. The nature of the money contributed determines how it is taxed. For example, **IF AN ANNUITY IS PURCHASED WITH REGULAR AFTER-TAX DOLLARS, THE INTEREST ACCUMULATES TAX FREE UNTIL THE OWNER WITHDRAWS IT.** Current law states that the interest must be withdrawn before the principal. That means the taxable portion comes out first, the tax free basis comes out last. **IF THE OWNER SELECTS A LIFE INCOME OPTION, THE TAXABLE EARNINGS ARE PRORATED WITH THE UNTAXED CONTRIBUTIONS, MAKING ONLY A PERCENTAGE OF EACH PAYMENT TAXABLE.** If the annuity is purchased with "before-tax" money, such as through a retirement plan, the earnings accumulate "tax free" and all distributions are 100% taxable.

THE FOLLOWING CHECKLIST GIVES AN OVERVIEW OF THE MANY INCOME SERVICES THAT SHOULD BE REPORTED ON THE INCOME SECTION OF FORM 1040. Remember, adding positive and negative numbers gives total income. Those items with a "☞" are usually added to gross wages with an explanation on the W-2 (WAGE AND TAX STATEMENT issued to all employees by their employer in January for the preceding year).

ITEMS TO INCLUDE AS INCOME:

___Alimony Received
___Awards & Prizes
___Bonuses ☞
___Commissions
___Business Expense Allowances ☞
___Back Pay ☞
___Dismissal Pay ☞
___Severance Pay ☞
___Sick Pay ☞
___Vacation Pay ☞
___Personal Use of Business Auto ☞
___Business Income (Loss)
(includes farming and fishing)
___Pension and Annuity Income
(taxable portion)

___Taxable Social Security Benefits
(if AGI exceeds certain limits)
___Interest Income
___Dividend Income
___Gross Wages
___Strike Benefits ☞
___Tips ☞
___Unemployment Compensation
___Royalties
___Capital Gains (Losses)
___Sale (Loss) of Business Property
___Gambling Winnings
___Partner's Share of Partnership Income or (Loss)
___S-Corporation Income (Loss)
___Rental Income (Loss)

Green **Adding positive and (negative) numbers gives total income**

YELLOW Adjustments to Income

(Locate and highlight this section on Form 1040)

KEOGH PLANS

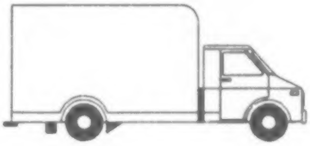
FROM TOTAL INCOME, SUBTRACT ALL ADJUSTMENTS. The most common adjustments to income are:

✓ Deductible IRA, Keogh, and SEP IRA contributions
✓ Penalties for early withdrawal of savings
✓ Special deductions for self-employed individuals
✓ Alimony paid
✓ Non-reimbursed moving expenses for a job relocation

THESE ADJUSTMENTS, SUBTRACTED FROM THE TOTAL INCOME, GIVE YOUR ADJUSTED GROSS INCOME, REFERRED TO AS "AGI."

Moving Expenses

YOU CAN DEDUCT UNREIMBURSED MOVING EXPENSES DUE TO A JOB RELOCATION IF THE DISTANCE BETWEEN THE NEW JOB AND YOUR FORMER HOME IS FIFTY MILES OR MORE. If you are an employee, you must remain in the new location for at least thirty-nine weeks during the twelve month period following the move. Self-employed persons must stay in the new location for seventy-eight weeks.



YOU CAN WRITE OFF THE FULL UNREIMBURSED COST OF MOVING YOUR HOUSEHOLD GOODS AND PERSONAL BELONGINGS. This includes fees paid to a moving company or money paid to rent a truck and to purchase packing materials. **YOU CAN ALSO DEDUCT THE FULL TRANSPORTATION COSTS FOR MOVING YOURSELF AND MEMBERS OF YOUR IMMEDIATE FAMILY TO THE NEW LOCATION.**

Yellow Adjustments give a deduction

TAX COMPUTATION

YELLOW Personal Exemptions

(Locate and highlight this section on Form 1040)

IN THE TAX COMPUTATION SECTION, SUBTRACT FROM ADJUSTED GROSS INCOME < AGI > THE PERSONAL EXEMPTION DEDUCTIONS FOR YOURSELF, YOUR SPOUSE, AND ALL YOUR DEPENDENTS. As mentioned earlier, this 1995 amount of $2,500 will increase each year according to the annual inflation rate.

YELLOW Standard and Itemized Deductions

(Locate and highlight this section on Form 1040)

THE STANDARD DEDUCTION IS ANOTHER WRITE-OFF WITH A SET AMOUNT FOR EACH FILING STATUS. It also increases each year according to the inflation rate. In 1995, it was $6,550 for couples filing jointly, $5,750 for heads of household, and $3,900 for singles. Blind persons and/or taxpayers over age sixty-five qualify for additional deduction amounts. These amounts increase each year, again with the inflation rate.

TAXPAYERS WITH DEDUCTIONS THAT EXCEED THE STANDARD DEDUCTION CAN CLAIM A LARGER SUM BY FILING SCHEDULE A–ITEMIZED DEDUCTIONS. When taxpayers itemize, they deduct amounts paid for state and local taxes, home mortgage interest, charitable contributions, and other expenses. Some of the

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deductions that have limitations are medical expenses, casualty and theft losses, and employee business expenses. For most taxpayers, itemizing is not possible without the write-off from home mortgage interest and property taxes. An explanation of itemized deductions follows this information about Form 1040.

TAXABLE INCOME EQUALS AGI (ADJUSTED GROSS INCOME) MINUS PERSONAL EXEMPTIONS AND EITHER THE STANDARD OR ITEMIZED DEDUCTION AMOUNTS. YOU USE TAXABLE INCOME TO FIGURE YOUR TAX LIABILITY. The tax tables cover taxable incomes between 0 and $50,000; taxable incomes over $50,000 must use the tax rate schedules.

This Section Calculates	
Yellow Deductions For: Personal & Dependent Exemptions	
Standard or Itemized Deductions	Red Tax Liability

BLUE Tax Credits

(Locate and highlight this section on Form 1040)

SOME CREDITS REDUCE TAX LIABILITY DOLLAR FOR DOLLAR, WHILE OTHER CREDITS ARE GIVEN AS A PAYMENT. DEPENDENT AND CHILD CARE CREDITS REDUCE TAX LIABILITY. 1995 tax law gives a 20% to 30% tax benefit based on income for child or dependent care. Up to $2,400 can be used for one qualifying person, and up to $4,800 for two or more qualifying persons. For those with adjusted gross incomes over $28,000, the top credit is $480 for one qualifying person, and $960 for two or more qualifying persons.

To take dependent and child care credits, both spouses or the head of household must either work, be looking for work, or be a full-time student. Also, the children must be under age thirteen or disabled. For married couples, the credit is figured on the lesser of the two incomes. If one spouse doesn't work, no credit is given. To receive the credit, in addition to the amount paid, the IRS requires the name, address, and tax identification number (social security number) of the person or facility performing the child or dependent care services.

The **CREDIT FOR THE ELDERLY AND DISABLED** is for individuals with lower incomes age sixty-five and older who receive little or no social security or railroad retirement benefits, or for persons under sixty-five receiving disability income who are permanently and totally disabled. Those who receive foreign income or who temporarily live in a foreign country or a U.S. possession can take a **FOREIGN TAX CREDIT** for foreign taxes paid. Another credit is available for mutual fund shareholders for the tax paid by the mutual fund on its **UNDISTRIBUTED CAPITAL GAINS**. Finally, other credits include a **FUEL TAX CREDIT**, a credit for the tax on **DIESEL FUEL**, and a tax credit for interest paid on qualifying **MORTGAGE CERTIFICATES**, and numerous **GENERAL BUSINESS CREDITS**.

Heads of household and married couples who have one or more dependent(s) and wages and adjusted gross income under a certain amount qualify for an **EARNED INCOME CREDIT**. The credit received depends on the wages earned and the number of dependents. Sometimes, employers will advance the earned income credit to qualifying employees to increase their current monthly income and help them meet their living expenses.

For tax years after 1994, childless workers between the ages of 25 and 65 with earned income of less than $9,000, who are not the dependent of another taxpayer, also qualify for the credit.

BLUE **Credits reduce your tax**

RED Other Taxes

(Locate and highlight this section on Form 1040)

In certain situations, you may have to add in other taxes. One such tax is the **SELF-EMPLOYMENT TAX**. It is assessed against all persons who are in business for themselves. **THIS TAX COVERS THEIR CONTRIBUTIONS FOR FICA AND MEDICARE. SINCE THE SELF-EMPLOYED HAVE NO EMPLOYER PAYING INTO SOCIAL SECURITY ON THEIR BEHALF, THEY MUST MAKE A DOUBLE CONTRIBUTION.** Although social security tax is subject to change, the self-employed will pay twice the amount paid by employees through withholding. They must pay for themselves and the "employer." Half of the self-employment tax qualifies for a deduction as an adjustment to income.

INDIVIDUALS UNDER AGE 59½ WHO TAKE MONEY OUT OF QUALIFIED RETIREMENT PLANS SUCH AS IRAS, 401(K)s, AND KEOGHS MUST PAY AN ADDITIONAL 10% TAX PENALTY ON THE DISTRIBUTION; NO OFFSETTING DEDUCTIONS CAN REDUCE THIS TAX PENALTY. Exceptions are rare. Two more common exceptions, however, are if the money is withdrawn to pay for medical expenses or to pay for educational expenses.

Persons who receive tips, but do not report them in full to their employer, will pay social security tax on this tip income when they file their tax return. **THESE 'ALLOCATED TIPS' ARE IDENTIFIED ON FORM W-2**, the wage and tax statement given out by employers in January. The additional social security tax is shown in this section.

ALTERNATIVE MINIMUM TAX affects the higher income brackets and those with tax preference items, such as excess depreciation and passive losses. It can add as much as an additional 21% to the balance due.

RED Other taxes increase your tax liability

BLUE Payments

(Locate and highlight this section on Form 1040)

IRS PAYMENT

Payments indicate the amount withheld by your employer for all taxes as well as other payments made during the year to meet your tax liability. These include estimated tax payments, payments made with extensions, and refunds applied from prior years.

Any tax credits given as payments also show in this section. They include: earned income credit, tax paid on gasoline and fuels (special situations only), and the mutual fund credit on undistributed dividends. Other payments shown here are excess social security taxes and excess RRRA taxes withheld.

APPLYING THE TOTAL PAYMENTS AGAINST THE TOTAL TAX LIABILITY WILL SOW EITHER A BALANCE DUE OR A REFUND.

BLUE Payments are applied toward taxes owed

SUMMARY OF FORM 1040

Each of the sections on Form 1040 are important in determining the amount of personal income tax due. The simplified forms 1040A and 1040EZ go through a similar process but with fewer steps.

- ✓ Determine your **FILING STATUS** and the number of **EXEMPTIONS** you can claim
- ✓ Add all your income, including negative numbers or losses
- ✓ Subtract adjustments from income to come up with **ADJUSTED GROSS INCOME (AGI)**
- ✓ From **ADJUSTED GROSS INCOME** subtract standard or itemized deductions and exemptions. This gives **TAXABLE INCOME.** The tax tables and tax rate schedules show the tax liability for different incomes and filing status' based on taxable income
- ✓ **ADDITIONAL TAXES** and/or **CREDITS**, when applicable, will lower or raise tax liability
- ✓ Apply all **PAYMENTS** to the total tax due for either a **BALANCE DUE** or a **REFUND**

Table 7.1 gives a summary of this process. Highlight each section with the appropriate color.

Table 7.1 SUMMARY OF THE 1040 SECTIONS

SECTION		*RESULT*
GREEN INCOME Add all income and losses	⇨	TOTAL INCOME
YELLOW ADJUSTMENTS Subtract all adjustments from total income	⇨	ADJUSTED GROSS INCOME
YELLOW TAX COMPUTATION Subtract the deduction for exemptions and standard or itemized deductions from adjusted gross income	⇨	TAXABLE INCOME
RED Take taxable income to: 1) the tax tables (under $50,000), or 2) the tax rate schedules (over $50,000)	⇨	TAX LIABILITY
BLUE CREDITS All credits reduce tax liability. Some are entered as payments.	⇨	NEW TAX LIABILITY
RED OTHER TAXES Add other taxes owed to the new tax liability	⇨	TOTAL TAX LIABILITY
BLUE PAYMENTS Add all payments, including credits given as payments	⇨	TOTAL PAYMENTS
REFUND OR BALANCE DUE **Apply payments to tax liability**		

ITEMIZED DEDUCTIONS (Schedule A)

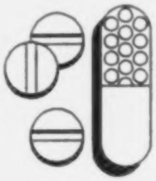
Schedule A is also divided into sections. Locate one of these forms and identify each section as you read about it. When certain write-offs exceed the standard deduction, taxpayers can take the higher amount by showing the details that reflect that higher amount on Schedule A, Itemized Deductions. The expenses falling into these categories are:

✓ MEDICAL EXPENSES
✓ INTEREST
✓ CASUALTY & THEFT LOSSES
✓ TAXES
✓ CONTRIBUTIONS
✓ MISCELLANEOUS DEDUCTIONS

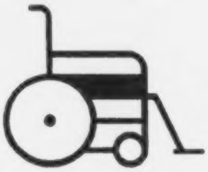
Medical Expenses

YOU CAN ONLY DEDUCT MEDICAL EXPENSES FOR YOURSELF, FOR YOUR SPOUSE, AND FOR YOUR DEPENDENTS TO THE EXTENT THESE EXPENSES EXCEED 7.5% OF YOUR ADJUSTED GROSS INCOME. For example, if your adjusted gross income is $30,000, you must subtract $2,250 from your total medical expenses before you have a deduction ($30,000 x .075 = $2,250). This 7.5% limitation removes medical expenses as a write-off for most taxpayers. For many, the medical deduction only applies during years when income is low, or when unreimbursed medical costs are high.

ALLOWED MEDICAL EXPENSES INCLUDE payments made for prescription medicines and drugs, and payments made to doctors, dentists, nurses, hospitals, and medical laboratories. Also deductible are amounts paid for insurance premiums, hearing aids, glasses, and dentures. When you put medical payments on a charge card, you can deduct the full amount in the year the charge occurs.



In addition, the IRS permits deductions for meals, lodging, and transportation costs directly related to medical treatments. The IRS publishes a standard mileage rate when personal automobiles are used for medical travel, or they allow for the actual cost of other transportation. They also allow a per-day lodging expense up to a certain limit.

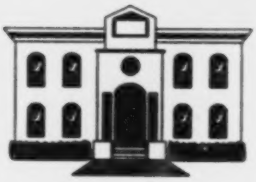


If you have a handicapped dependent, you can deduct qualifying school expenses. Also, if you must alter your home to accommodate a dependent's handicap, you can deduct all or part of the alteration expense.

If you are unable to claim a dependent relative only because their income is too high, but you pay for their health care, you may be able to take off the portion you pay. Generally speaking, all unreimbursed costs for treating an ailment or handicap suffered by yourself or someone you support are eligible expenses.

THE IRS DOES NOT CONSIDER HEALTH OR BEAUTY MAINTENANCE A MEDICAL EXPENSE, so health club dues, face lifts, vitamins, bottled water, cosmetics, and weight loss programs are not deductible. If a doctor, however, prescribes a certain weight loss program because one's health is in danger, or prescribes vitamins to treat a specific ailment, the expenses then qualify for a deduction.

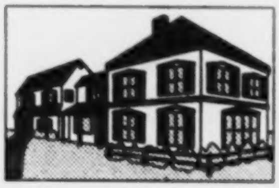
Taxes



YOU DEDUCT TAXES IN THE YEAR PAID. THIS INCLUDES REAL ESTATE TAXES ON PROPERTY YOU OWN, STATE AND LOCAL INCOME TAXES, AND PERSONAL PROPERTY TAXES ASSESSED BY LOCAL OR STATE GOVERNMENTS. If you pay a prior year's property taxes in another year, you should deduct them in the year paid.

Prepaying state and local taxes may increase deductions enough to allow itemization in certain years. Be aware, however, if you consistently or deliberately overpay your state taxes just to secure this write-off, the IRS can disallow the deduction.

Interest Expense



YOU CAN DEDUCT HOME MORTGAGE INTEREST ON TWO HOMES AS LONG AS YOUR TOTAL DEBT ON BOTH MORTGAGES DOESN'T EXCEED ONE MILLION DOLLARS. Also, you can deduct points paid to get a loan to purchase your primary residence if:

- ✓ The charging of points is an established business practice in your area
- ✓ The points are not excessive
- ✓ The money you pay for total closing costs is equal or greater than the points paid. Money for "deductible" points cannot come from loan proceeds

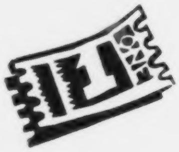
If you refinance to use some of your home's equity for other expenses, up to $100,000 of the new loan will qualify as home mortgage interest. The points charged on a refinance must be amortized over the life of the loan. If you pay off this refinanced loan at a later date, the points not deducted can be taken in full the year the loan is paid off. When you refinance to remodel or do home improvements, the rules differ and points allocated toward money used for improvements can be deducted in full in the year paid.

Personal interest such as car loans, credit card interest, and bank loans are no longer deductible. **INVESTMENT INTEREST (INTEREST ON LOANS USED TO PURCHASE INVESTMENTS) CAN ONLY BE USED TO OFFSET INVESTMENT INCOME.**

Charitable Contributions

YOU CAN DEDUCT DONATIONS MADE TO QUALIFIED, NON-PROFIT, CHARITABLE ORGANIZATIONS. YOU CAN DONATE EITHER MONEY OR PROPERTY. All cash contributions over $250 must have receipts. If you donate property, your deduction equals the item's fair market value—the price you could sell it for at a garage sale or through an advertisement. In order to claim a write-off for a non-cash contribution that exceeds $250 in value, the items donated, their purchase price, and fair market value need to be listed on Form 8283.

ALL PROPERTY ITEMS, OTHER THAN PUBLICLY TRADED SECURITIES, EXCEEDING $5,000 IN VALUE MUST BE APPRAISED. Your deduction for charitable contributions is limited to 50% of your adjusted gross income, but you can carryover the excess to the next year.



If you buy a ticket for a sporting event, a dinner, or a program offered through a charitable organization, you cannot write off the total amount. You can only deduct the contribution, not the amount that covers the dinner or the activity enjoyed. The organization should be able to tell you the amount of your charitable contribution for each ticket purchased.

YOU CAN TAKE A MILEAGE DEDUCTION FOR TRAVEL WHEN YOU DONATE YOUR TIME TO A CHARITY. You can also deduct nonreimbursed meal and lodging expenses incurred while volunteering your services in charitable projects. Under no circumstances can you write off the value of your donated time.

Casualty and Theft Losses

A CASUALTY LOSS RESULTS FROM A SUDDEN AND UNEXPECTED EVENT SUCH AS AN EARTHQUAKE, HURRICANE, FIRE, FLOOD, OR AN AUTOMOBILE ACCIDENT THAT DESTROYS PERSONAL OR BUSINESS PROPERTY. Theft losses must be verified by a police report.

If your loss is insured, you must file an insurance claim for the damages. The amount of loss is the lesser of the property's adjusted basis or the decrease in its fair market value after the casualty or theft. This amount must then be reduced again by the amount of the insurance reimbursement.

EACH PERSONAL CASUALTY AND THEFT LOSS IS FIRST REDUCED BY $100. THEN, THE TOTAL OF ALL UNREIMBURSED PERSONAL LOSSES MUST EXCEED 10% OF YOUR ADJUSTED GROSS INCOME BEFORE YOU HAVE A DEDUCTION. For example, if your adjusted gross income is $30,000 and you have a loss of $5,000 after insurance reimbursement, you can only deduct $1,900.

$5,000 Loss	$30,000 AGI	$4,900 Allowed Loss
- 100	x 10%	- 3,000 10% of AGI
$4,900	$ 3,000	**$ 1,900 Casualty & Theft Loss Deduction**

IN DIFFERENCE TO PERSONAL LOSSES, YOU CAN DEDUCT A BUSINESS CASUALTY AND THEFT LOSS IN FULL. Damaged or stolen property used partially for business generates a partial business deduction and a partial personal deduction. Only the personal portion is subject to the $100 and the 10% of adjusted gross income reduction.

If you suffer a loss of property in an area designated as a national disaster area qualifying for federal assistance, special rules apply. **YOU CAN TAKE THE LOSS EITHER IN THE YEAR IT OCCURS, OR IN THE PRECEDING YEAR.** By taking the loss in the previous year, you can file an amended return and claim an immediate refund for prior taxes paid.

Special rules apply to designated national disaster areas

Example:

Bob and Betty Barnes paid $8,460 in taxes in 1994. In 1995, they lost their home and most of their possessions in a fire. The area was later designated a national disaster area. After insurance reimbursements, their loss of $40,000 brought their taxable income to zero. They could immediately file an amended tax return (Form 1040X) for 1994 and use the 1995 loss to receive a refund for the $8,460 they paid in 1994.

Miscellaneous Deductions

MOST MISCELLANEOUS DEDUCTIONS MUST EXCEED 2% OF YOUR ADJUSTED GROSS INCOME BEFORE ANY PERMITTED DEDUCTION. The most common employee business expenses are uniforms, unreimbursed travel, union dues, professional dues, job hunting expenses, and 50% of business meals and entertainment. Other deductions include tax preparation fees, appraisal fees for casualty losses and/or charitable contributions, IRA, keogh and other administrative fees, and management and investment expenses.

CAPITAL GAINS AND CAPITAL LOSSES

(reported on the income section)

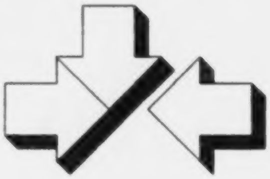
A capital gain or loss occurs when you sell real estate, limited partnerships, stocks, bonds, collectibles, hard assets, and many other investments. **SELLING AN INVESTMENT OR ASSET FOR MORE THAN ITS NET COST RESULTS IN A CAPITAL GAIN. SELLING AN INVESTMENT OR ASSET FOR LESS THAN ITS NET COST GIVES A CAPITAL LOSS.**

LOSS

THE IRS HAS NO LIMIT ON CAPITAL GAINS. CURRENTLY, THE MAXIMUM TAX RATE YOU WILL PAY ON CAPITAL GAINS IS 28%. THE IRS DOES LIMIT CAPITAL LOSSES TO A TOTAL DEDUCTION OF $3,000 EACH YEAR. This means if Dan loses $5,000 in one year from selling an investment, he can only write off $3,000, and must carry forward the balance ($2,000) to the next tax year. You can carry a capital loss forward for as many years as necessary to absorb the entire loss, but you can deduct no more than $3,000 in any year.

TAX FREE EXCHANGES (1034 EXCHANGE)

Generally, a nontaxable exchange postpones a recognized (taxable) gain. No taxable event occurs when you exchange one piece of qualified property for similar property. You can defer the gain until you sell the property received in the exchange. **ONLY BUSINESS AND INVESTMENT PROPERTY SUCH AS REAL ESTATE, STOCKS AND BONDS, OR BUSINESS EQUIPMENT CAN BE USED IN A TAX FREE EXCHANGE.** You can postpone part or all of a possible taxable gain when you trade for "like" property that has an equal or greater value. **THE PROPERTIES EXCHANGED CAN HAVE NO PERSONAL USE.**



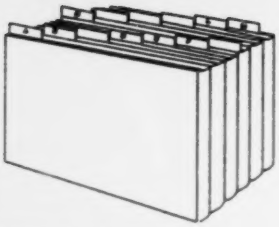
Example:

Wilma and Kevin own a piece of land worth $125,000. They paid $30,000 for it. If they sell the land, they will have approximately $95,000 to pay in capital gains (minus sales expenses). They can trade investment real estate for other investment real estate of equal or greater value and owe no tax until the new property sells by following all the rules for a tax free exchange.

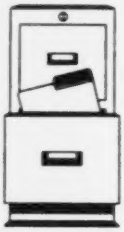
If Wilma and Kevin decide to do an exchange, ALL the proceeds from the sale must go into a trust fund held by a qualified third party such as a title company. They have 45 days from the sale of the old property to identify another property, then six months to purchase that property. The new property will be purchased from the trust fund. Any cash or unlike property (referred to as boot) received by them from the transaction is usually taxable. Any cash received from the transaction is taxable. Also, if they have a mortgage on the property traded that the buyer assumes, the mortgage must be accounted for in the trade. Relief of mortgage debt is taxable. This occurs when the old mortgage given up is more than a new mortgage assumed.

Numerous rules, not mentioned here, apply to tax free exchanges. Because the rules are complicated, be sure to seek tax advice and know what you are doing before attempting one of these trades.

RECORD KEEPING



Keeping tax records in order doesn't have to be complicated. File folders or a labeled accordion file work well. **SAVING TIME IS AN IMPORTANT CONSIDERATION, SO SET UP AN EASY SYSTEM WHERE YOU CAN SIMPLY DROP RECEIPTS AND STATEMENTS INTO THE DESIGNATED FILES OR POCKETS THROUGHOUT THE YEAR.** This saves looking through drawers, desks, shoeboxes, and glove compartments at tax time to find needed receipts. Select labels that fit your situation. You might want to color code your labels to correspond with the sections on Form 1040. **WHATEVER SYSTEM YOU USE, KEEP IT SIMPLE. TWO TO FOUR CATEGORIES IN YOUR SYSTEM ARE ADEQUATE FOR MOST TAXPAYERS. IF YOU HAVE BUSINESS EXPENSES, RENTAL PROPERTIES, OR BUY AND SELL NUMEROUS INVESTMENTS, YOU WILL NEED TO EXPAND YOUR CATEGORIES.**



THESE ARE THE RECORDS YOU NEED.
CHECK THE ONES THAT APPLY TO YOUR SITUATION.

GREEN **INCOME**

___ W-2 wage statements from employers
___ All 1099s for commission income, interest, dividends, & miscellaneous income
___ Statements showing state tax refund
___ Pension/annuity statements or Form 1099R
___ Disability and/or unemployment statements
___ Year-end bank statements showing interest earned
___ Records showing alimony received
___ If you sell investments such as real estate, stocks, bonds, mutual funds, or limited partnerships, statements showing:
    Amount paid and date of purchase
    Date of sale and amount received
___ K-1s for all limited partnerships and trusts

YELLOW **DEDUCTIONS**

___ IRA and Keogh deductions
___ Alimony paid
___ Out-of-pocket medical expenses exceeding 7.5% of AGI
___ Total medical insurance reimbursement
___ Home mortgage interest paid
___ Real estate taxes paid
___ Additional state/local taxes paid (other than withholding)
___ Personal property taxes paid
    Includes automobiles, recreational vehicles, etc.

YELLOW **DEDUCTIONS** (continued)

___ Cash charitable contributions
Receipts needed if over $250
___ Non-cash charitable contributions
If over $250, itemized list showing purchase price, date of purchase, and fair market value of all items. Name of organization which received the property. Signature of recipient and appraisal is needed for all items over $5,000
___ Total of each casualty or theft loss and insurance reimbursement
___ All employee business expenses and reimbursements
Include uniforms, union dues, meal expenses, and job hunting expenses.
___ Tax preparation fees
___ Investment expenses
Custodial fees, safe deposit box, brokerage and management fees, etc.

BLUE **PAYMENTS AND CREDITS**

___ Child care expenses
___ Estimated tax payments made
___ Taxes paid with extensions

RED **TAX NOTICES**

___ IRS notices and letters

SPECIAL TAX SITUATIONS

Buying or Selling a Home

___ Escrow closing statement for home sold
___ Escrow closing statement for home purchased
___ Closing statements or tax return showing purchase price, costs, and amount of any previously deferred gains
___ Receipts for all home improvements

Claiming Dependents (other than children living with you)

___ Total amount paid for support
___ Total income received by person being claimed
___ Proof to show you provided over 50% of their care. Include expenses for lodging, food, child care, clothing, education, and health care

Moving Expenses for Job Relocation

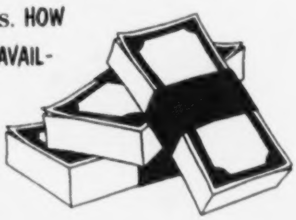
___ Cost of moving household goods
___ Mileage from former residence to new job site
___ Total reimbursement by employer

PART III

How Money Grows

Dollars will multiply and grow only when you put them to work. **CHAPTER 8 TELLS ABOUT SAFE OPTIONS FOR SAVINGS ACCOUNTS.** Bank savings offer a federal guarantee, small minimums, and convenience. Banks have several types of accounts. Government securities or a contract with an insurance company are options that can increase your yield with little compromise in safety.

When you are serious about making your money grow, consider investments. Although investments have higher risks, they also have higher rewards. **HOW INVESTMENTS ARE SOLD, WHY THEY RISE AND DECLINE, AND THE NUMEROUS CHOICES AVAILABLE TO INVESTORS ARE COVERED IN CHAPTER 9. FOR MANY, HOME OWNERSHIP IS A WISE INVESTMENT. THE DETAILS COME IN CHAPTER 10.** This entire section explores the many available opportunities you have to put your money to work.



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Chapter 8

Savings

HAVE TWO SAVINGS ACCOUNTS

Emergency Fund Savings (A Short-Term Account)

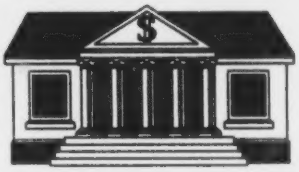
The first step toward a secure financial future begins with an emergency fund savings account as a base. This account should be "liquid," that is, it can be readily turned into cash. **YOUR EMERGENCY FUND IS THE FIRST STEP TOWARD WISE PLANNING BECAUSE IT GIVES YOU EXTRA MONEY FOR UNEXPECTED EXPENSES.**

The first step toward a secure financial future begins with an emergency fund savings account as a base

PASSBOOK ACCOUNT ADVANTAGES

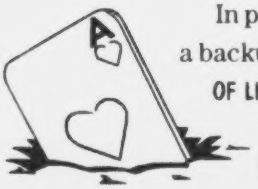
- ✓ Convenience
- ✓ Small Minimum
- ✓ Liquidity
- ✓ Guarantees

If you are just starting to save, your best bet is to open a **PASSBOOK ACCOUNT** with a local commercial bank or open an account in a **MONEY MARKET FUND. BOTH OFFER INSTANT LIQUIDITY, WHICH IS THE MOST IMPORTANT CONSIDERATION FOR AN EMERGENCY FUND.** Until you have saved enough to cover one to three months of living expenses, don't tie up your money for a fixed term, making it unavailable on the spot if needed.



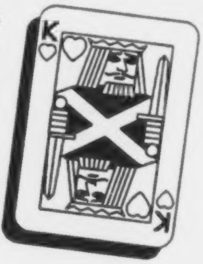
ALSO, DON'T LET TOO MUCH MONEY ACCUMULATE IN YOUR "EMERGENCY" ACCOUNT. Other savings options offer tax advantages and/or higher yields, although they have less liquidity.

Your "Ace in the Hole" (A Long-Term Account)



In poker, an "ace in the hole" is a card you hold back and don't use so you have a backup if another player puts down a high card you didn't anticipate. **IN THE GAME OF LIFE, YOU ALSO NEED AN 'ACE IN THE HOLE' AS A BACKUP TO GIVE YOU THE WINNING EDGE. THIS 'ACE' IS A LONG-TERM SAVINGS ACCOUNT.** Then, when you want money beyond your short-term needs, the "ace" will cover you. Hopefully, you won't need a backup, but having an "ace" fosters security.

MAKE A COMMITMENT TO YOURSELF RIGHT NOW TO TAKE A MINIMUM OF 10% (MORE IF YOU CAN) FROM EVERY PAYCHECK AND PRETEND YOU NEVER EARNED IT. PUT IT IN AN ACCOUNT AND LEAVE IT ALONE; IT WILL BECOME YOUR 'ACE IN THE HOLE.' Don't use it to buy new tires or get the kids school clothes. Assume this "ace" doesn't exist. Think of it as a way of paying yourself for your hard work and accomplishments. You pay others for their services, so you owe at least this much to yourself. Your "ace" will increase in value over the months and years. As it does, take out some of the money and invest it. Having extra money to cover your future is wise planning.



Good card players try to protect their ace so they don't have to play it prematurely. **YOU CAN USE THE ACE TO ITS BEST ADVANTAGE WHEN YOU HAVE ANOTHER HIGH CARD AS A COMPANION.** In cards, a king, a queen, or a jack works fine. In life, **THIS 'HIGH CARD' IS YOUR PRIMARY OR SHORT-TERM SAVINGS ACCOUNT.** It will take care of unexpected expenses such as car and home repairs, or sudden trips to see ill family members. This emergency fund protects your long-term account, just like the king or queen protects the ace. Such a strategy assures a winning edge in the money game.

HOW MUCH CAN YOU SAVE?

DO YOURSELF A FAVOR AND GIVE YOUR MONEY GOALS PRIORITY. Start with a savings plan you can afford. Decide now how much you can put away each month, and begin with your next paycheck. **USE TABLE 8.1 TO HELP.** Look at this table to see how much you will accumulate within a certain time period if you save consistently. Interest earnings and time will make your dollars grow.

Table 8.1 HOW WEEKLY SAVINGS ACCUMULATE WITH INTEREST & TIME

SAVE $5 A WEEK

	5 Years	10 Years	15 Years	20 Years	25 Years
4%	$1,439	$3,195	$5,341	$7,962	$11,162
6%	$1,515	$3,560	$6,319	$10,044	$15,071
8%	$1,597	$3,979	$7,530	$18,615	$20,728

SAVE $10 A WEEK

	5 Years	10 Years	15 Years	20 Years	25 Years
4%	$2,877	$6,391	$10,682	$15,923	$22,324
6%	$3,030	$7,120	$12,639	$20,088	$30,141
8%	$3,194	$7,957	$15,061	$25,655	$41,455

SAVE $25 A WEEK

	5 Years	10 Years	15 Years	20 Years	25 Years
4%	$7,193	$15,977	$26,705	$39,808	$55,810
6%	$7,575	$17,799	$31,597	$50,219	$73,353
8%	$7,985	$19,893	$37,652	$64,138	$103,638

SAVE $50 A WEEK

	5 Years	10 Years	15 Years	20 Years	25 Years
4%	$14,385	$31,954	$53,410	$79,619	$111,620
6%	$15,150	$35,598	$63,194	$100,439	$150,705
8%	$15,969	$39,786	$75,304	$128,276	$202,276

WHERE TO SAVE

Bank and Credit Union Accounts

YOU CAN OPEN A PASSBOOK ACCOUNT AT A BANK FOR AS LITTLE AS $5. Commercial banks and credit unions all offer various savings plans. Some include checking accounts that earn interest. **MOST OF THESE ACCOUNTS ARE FEDERALLY INSURED UP TO $100,000. PASSBOOK ACCOUNTS OFFER CONVENIENCE, SMALL INITIAL DEPOSITS, INSTANT LIQUIDITY, AND SAFETY.**

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CERTIFICATES OF DEPOSIT
$
$
$

By giving up some liquidity through tying up your money for fixed time periods, you can earn higher interest in **CERTIFICATES OF DEPOSIT (CD'S). THE MINIMUM DEPOSIT FOR CD'S VARY FROM $500 TO $10,000.** Their interest is guaranteed for the life of the certificate, which varies in length from three months to ten years. The earnings can compound if you "roll" the entire amount from one certificate into a new certificate at the end of the term.

THE MOST COMMON CD'S HAVE A TERM OF SIX OR TWELVE MONTHS. It is possible, however, to lock in an interest rate for five years or even longer. Be aware that if interest rates rise while you have money tied up in a long-term certificate, you will not be able to take advantage of the higher rates unless you withdraw your funds, take a penalty for early withdrawal, and reinvest the money at the higher rate.

Money Market Accounts

Money Market Accounts through Savings Institutions

For years, large corporations have used the money market to "park" their extra cash. It is called the money market because the investments are in money. **THE MONEY MARKET OFFERS HIGHER YIELDS THAN BANK YIELDS WHILE MAINTAINING SHORT-TERM LIQUIDITY.** The investments are often **U.S. GOVERNMENT SECURITIES** and short-term corporate debt called **COMMERCIAL PAPER**. For a minimum purchase of $100,000, corporations have a place to put their extra cash for a short term and earn average or above average interest rates.

COMMERCIAL PAPER

Banks, savings institutions, and mutual funds now offer the same money market opportunities to their investors, but with affordable initial deposits. These deposits vary. Some start as low as $100. **USING THE DEPOSITS FROM MANY INVESTORS, THE INSTITUTION PURCHASES A BROAD RANGE OF HIGH YIELDING, LIQUID MONEY INSTRUMENTS SIMILAR TO THOSE PURCHASED BY CORPORATIONS.** These money market accounts make it possible for individuals to have liquidity while earning at higher interest rates than passbook accounts.

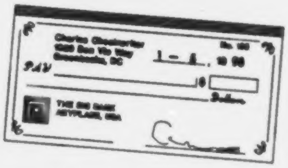
MONEY MARKET

Money market accounts offered by banks, savings and loans, and credit unions have low minimum deposits, usually $1,000, and are federally insured. They usually have higher yields than passbook accounts, but may have maintenance fees and penalties for early withdrawal. Most have limited check writing privileges.

Money Market Accounts through Mutual Funds

MONEY MARKET ACCOUNTS WITH MUTUAL FUNDS ARE ONE FUND WITHIN A FAMILY OF FUNDS, OFTEN REFERRED TO AS THEIR 'CASH' FUND. The cash fund will invest only in money investments such as short-term commercial paper and U.S. Government Securities. **THIS CASH FUND IS DESIGNED TO OFFER THE HIGHEST POSSIBLE YIELD WHILE MAINTAINING INSTANT LIQUIDITY.** The fund has a professional manager who purchases new money investments when the older ones mature. For example, the manager may purchase a $1 million, 4% interest note for three months. When that note matures at the end of the three months, the manager will buy another money investment.

To participate in money market mutual funds, you do not have to purchase other funds within the family. **MOST OF THESE MONEY MARKET ACCOUNTS HAVE INITIAL DEPOSITS BETWEEN $500-$1,000 AND ACCEPT ADDITIONAL CONTRIBUTIONS OF SMALLER AMOUNTS.** Once money has been on deposit for thirty days, the account usually allows unlimited check writing. The minimum check amount varies for different funds, but range from $100 to $500. **MONEY MARKET ACCOUNTS HAVE NO SALES CHARGES, AND THE BALANCE CAN BE WITHDRAWN AT ANY TIME WITHOUT PENALTY. THE INTEREST RATE CHANGES DAILY AND COMPOUNDS DAILY.** Most major newspapers list the prior day's annual yield. **GENERALLY SPEAKING, MUTUAL FUND MONEY MARKET FUNDS PAY A HIGHER INTEREST RATE AND HAVE FEWER RESTRICTIONS THAN THOSE OFFERED THROUGH SAVINGS INSTITUTIONS.**



MONEY MARKET MUTUAL FUNDS ARE NOT FEDERALLY INSURED. They are considered "safe," however, since they only purchase short-term money investments. You can also purchase federally insured money market accounts through mutual funds, but they will pay a lower yield. With these accounts, 100% is invested in U.S. Treasury obligations.

U.S. Government Securities

U.S. GOVERNMENT SECURITIES ARE BONDS, OR OBLIGATIONS OF THE U.S. TREASURY, BACKED BY THE FAITH AND CREDIT OF THE U.S. GOVERNMENT. You can buy government securities direct or through a mutual fund that invests only in government securities. (Mutual funds and bonds are covered in detail in Chapter 9, *Investments.*)

Investors purchase government securities for a certain time period, with a guaranteed interest rate. Like certificates of deposit, the owner must reinvest the entire sum to gain the benefits of compound growth. The interest does not compound automatically. Government securities are often purchased by banks, insurance companies, corporations, mutual funds, foreign governments, and individual investors.

U.S. GOVERNMENT SECURITIES OFFER A TAX ADVANTAGE FOR THOSE WHO HAVE HIGH STATE TAXES. THE INTEREST EARNED IS NOT TAXABLE BY STATE OR LOCAL GOVERNMENTS. Safety and guaranteed yields are other attractions. If you want to earn compound interest, you must do your own compounding by reinvesting the principal plus earnings into another account at maturity.

TREASURY BILLS are short-term debt instruments with maturity dates of three, six, or twelve months. The minimum investment is $10,000, with additional purchases in $5,000 increments. **TREASURY BILLS ARE SOLD AT A DISCOUNT, THEN HELD TO MATURITY TO COLLECT THE INTEREST.** For example, if you buy a $10,000 treasury bill at 8% interest for one year, you would pay $9,200 to purchase the bill and receive $10,000 one year later. The discount of $800 is the 8% interest earned on $10,000.

TREASURY NOTES AND TREASURY BONDS PAY INTEREST SEMIANNUALLY, SIMILAR TO MANY CD'S. They have a guaranteed yield with varying maturity dates. The minimum investment for **TREASURY NOTES** is $1,000 for maturity dates ranging from four to ten years and $5,000 for maturity dates of less than four years. **TREASURY BONDS** have a minimum investment of $5,000, with additional purchases of $1,000. The holding period is long-term, ranging from ten to thirty years.

You can purchase government securities (Treasury Bills, Treasury Notes, Treasury Bonds) through a securities broker or through a commercial bank. Both charge a fee. To save the fee, you can make your purchase directly from one of the twelve Federal Reserve Banks (listed in the Appendix). Another option, which includes a small sales charge, is to buy a diversified holding of government securities through a mutual fund.

SERIES EE SAVINGS BONDS have low denominations. The minimum purchase is $50 with additional purchases of $25 or more. **SERIES EE BONDS ARE BOUGHT AT A DISCOUNT THEN HELD TO MATURITY TO RECEIVE THE INTEREST.** If held at least five years, these bonds pay 85% of the average rate for treasury securities or 4%, whichever is greater. **LIKE OTHER U.S. OBLIGATIONS, THE INTEREST IS EXEMPT FROM STATE AND LOCAL TAXES. THE OWNER CAN ELECT TO PAY INTEREST ANNUALLY OR PAY ALL THE INTEREST WHEN THE BONDS ARE REDEEMED.**

WHEN PEOPLE AT LEAST TWENTY-FOUR YEARS OF AGE BUY THESE BONDS TO FUND COLLEGE TUITION AND FEES FOR THEMSELVES, THEIR SPOUSE, OR THEIR DEPENDENTS, AND USE ALL OF THE PROCEEDS FOR QUALIFIED EDUCATIONAL EXPENSES, ALL OF THE INTEREST IS EXEMPT FROM TAX. If this might fit your situation, check the rules, as income restrictions apply. (See Chapter 16, *Planning*, for more information about using Series EE Bonds to fund a college education.)

Insurance Companies

Cash Value Life Insurance

Cash value in a universal life or whole life insurance policy can serve as an excellent long-term savings. You need a flexible policy that pays current rates and has a low interest loan. **THE CASH VALUE WITHIN A LIFE INSURANCE POLICY OFFERS THE ADVANTAGES OF COMPOUND, TAX DEFERRED GROWTH, WITH A GUARANTEE BACKED BY THE ASSETS OF THE INSURANCE COMPANY.** One drawback is that it takes several years to build up the cash value in a policy before the owner has money available to borrow. Also, it could take ten days or longer to receive a check from the insurance company once you request a loan.

With savings in a life insurance policy, the policy owner must give up the policy or borrow from the cash value to take any money out. Such borrowing without paying back the loan will reduce the amount payable to beneficiaries should the insured die before the loan is repaid.

Annuities

For persons over age 59, annuities have several advantages. The interest is often higher than that paid by banks and it grows tax deferred. With most contracts, you have access to 10% or more of your policy face amount without penalty. Should you die, the accumulated value of the policy will pass to your named beneficiarles and avoid probate.

Each annuity contract is written for a time period, normally ranging from five to ten years. When you take ALL of the money out prematurely, penalties apply. For example, if you purchase a five year contract, the penalty for premature withdrawal during the first year might be 5% of the contract price. The second year it declines to 4%, the third year to 3%, etc.

Most contracts allow you to take 10% each year free of penalty. With some companies, the 10% free withdrawal accumulates. If you didn't use it the first year, you could take 20% the second year. Then, if you didn't use the 10% free withdrawal the first or second year, you could take 30% the third year and so on.

These contracts are not as flexible for people under age 59. All withdrawals are subject to the 10% tax penalty referred to in Chapter 7, *Personal Income Taxes—Other Taxes.*

SUMMARY

Where you place your savings dollars is not as important as your decision to save. **START THE HABIT OF SAVING CONSISTENTLY SO MONEY WILL BE AVAILABLE WHEN YOU NEED IT.**

Where you place your savings dollars is not as important as your decision to save

When choosing an account for your savings dollars, consider:

- ✓ Safety
- ✓ Liquidity and access
- ✓ Minimum investment
- ✓ Tax advantages
- ✓ Method of paying interest

Table 8.2 gives a summary of the many options available for savings dollars.

Table 8.2 SAFE OPTIONS FOR SAVINGS

ACCOUNT	FEDERALLY INSURED	MINIMUM INVESTMENT	INSTANT LIQUIDITY	STATE TAX	COMPOUND INTEREST
Passbook	Yes	$5	Yes	Yes	Yes
Certificate of Deposit	Yes	$500	No	Yes	Not Automatic
Money Market w/Savings Inst.	Yes	$1,000	Yes	Yes	Yes
Money Market Mutual Funds	No	$100	Yes	Yes	Yes
Series EE Bonds	Yes	$25	No	No	No
Treasury Bills	Yes	$10,000	No	No	No
Treasury Notes	Yes	$1,000, $5,000	No	No	No
Treasury Bonds	Yes	$5,000	No	No	No
Cash Value Life Insurance	No	Varies	Borrow	No	Yes
Annuities	No	$1,000-$5,000	Partial	Tax Deferred	Yes

Chapter 9

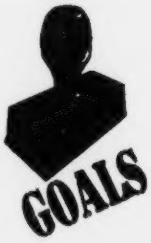
Investments

INTRODUCTION TO INVESTMENTS

INVESTING ALLOWS YOU TO INCREASE YOUR RATE OF RETURN, AND OVERCOME THE BITE TAKEN OUT BY INFLATION AND TAXES. For the higher return, you give up one or more of the advantages offered by fixed interest savings accounts. It may be the guarantee, the liquidity, the compound interest, or all of these.

To successfully invest, you must match the objective of the investment with your investment purpose. You will read about **BONDS, STOCKS, MUTUAL FUNDS, AND LIMITED PARTNERSHIPS. ALL COME IN MANY VARIETIES.** (This book does not cover the more sophisticated, higher risk choices such as puts, calls, warrants, options, and commodities.)

To successfully invest, you must match the objective of the investment with your investment purpose



YOUR INVESTMENT PORTFOLIO SHOULD REFLECT YOUR INVESTMENT GOALS AND YOUR RISK COMFORT LEVEL. For example, you would not be happy investing in small company growth stocks if you want consistent earnings and would worry about your principal decreasing. **MOST INVESTMENTS HAVE SOME KIND OF RISK, AND YOU AS AN INVESTOR NEED TO BE COMFORTABLE ASSUMING THAT RISK FOR THE TRADE-OFF OF POTENTIALLY HIGHER RETURNS.**

The length of time your money will be invested is equally important. **IF YOU HAVE TWENTY YEARS BEFORE YOU'LL NEED THE MONEY, YOU CAN BE MORE AGGRESSIVE THAN IF YOU'LL NEED THE MONEY IN THREE YEARS.** Generally, a higher risk generates a higher return, but if the risk is too high, you can lose your principal. **MOST IMPORTANTLY, YOUR INVESTMENT DOLLARS NEED A PURPOSE.** You must decide if you need growth, income, or a combination of growth and income. Investment purpose is covered in Chapter 15, *Priorities*.

Rarely are investments guaranteed—if they were, they wouldn't be investments. **PEOPLE WHO INVEST BECOME 'OWNERS' OR 'LOANERS' IN SOME ASPECT OF AMERICAN OR WORLD INDUSTRY. SECURITIES** cover the broad spectrum of investments, which includes "loaners" who want a fixed income, and "owners" who want a share of the action. Investments that "own" are often referred to as **'EQUITIES.'** Securities include stocks, bonds, mutual funds, real estate shares, oil wells, mortgage pools, movie rights, and equipment. The makeup of each security determines its risk level and profit potential.

SECURITIES & EXCHANGE COMMISSION

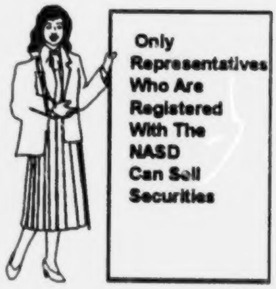
The Securities & Exchange Commission regulates the securities industry

All investments sold to the public raising over $500,000 must be registered with the Securities and Exchange Commission (SEC). **CONGRESS ESTABLISHED THE SEC TO ELIMINATE POTENTIAL ABUSES WITHIN THE SECURITIES INDUSTRY SUCH AS INVESTORS NOT RECEIVING ALL PERTINENT FACTS ABOUT AN INVESTMENT.** The SEC has many rules to enforce full disclosure and to protect investors. **ONE OF THEIR SUBSIDIARIES, THE NATIONAL ASSOCIATION OF SECURITIES DEALERS (NASD), SUPERVISES BROKERAGE FIRMS AND THOSE FIRMS' REPRESENTATIVES.** Before taking an order, the NASD requires all salespersons offering public investments to give potential investors a prospectus. **A PROSPECTUS IS A LEGAL DOCUMENT, APPROVED BY THE SEC. IT DISCLOSES ALL RELEVANT FACTS ABOUT THE INVESTMENT.**

The prospectus discloses the important details of the investment

Although the SEC has to approve every public offering, this approval does not endorse the investment's safety. The SEC does require, however, that the offering party reveal all pertinent facts regarding the investment in a prospectus. **THE PROSPECTUS COVERS THE INVESTMENT'S OBJECTIVE, THE FINANCIAL CONDITION OF THE OFFERING PARTY, HOW THE MONEY CONTRIBUTED BY INVESTORS WILL BE SPENT, THE RISKS OF OWNERSHIP, SALES CHARGES, EXPENSES, AND MANAGEMENT FEES.** The information in the prospectus helps securities brokers, registered representatives, and investors to evaluate a security and determine its suitability.

ONLY REPRESENTATIVES WHO ARE REGISTERED AND APPROVED BY THE NASD CAN SELL SECURITIES. To become licensed, they must complete an extensive training program and pass a difficult securities test. The NASD also screens its applicants to see if they have any prior history of not working in the public's best interest. **THE NASD SUPERVISES ALL INVESTMENT FIRMS AND THEIR REPRESENTATIVES TO ASSURE THEY FOLLOW THE INDUSTRY'S RULES OF FAIR PRACTICE, WRITTEN TO PROTECT INVESTORS FROM FORESEEABLE ABUSES.**



SIPC

To protect investors further, in 1970 Congress passed the Securities Investor Protection Act, or SIPC, to stop investor loss if a brokerage firm fails. SIPC is self-insured, with each member firm paying an annual assessment to the SIPC fund. Then, should SIPC need more money, it has a line of credit with the United States Treasury. When an SIPC member cannot pay off its customers, SIPC takes over and appoints a trustee to liquidate the assets of the firm and make the promised payments.

SIPC insurance covers all stocks, bonds, notes, and certificates of deposit held by a covered member brokerage firm. The trustee can settle claims up to a maximum of $500,000 for each customer, but this settlement can contain no more than $100,000 in cash. **SIPC INSURANCE DOES NOT PROTECT A BROKERAGE ACCOUNT FROM MARKET UPS AND DOWNS; IT PROTECTS THE ASSETS OF AN ACCOUNT WHEN A MEMBER OF SIPC FAILS AND CANNOT MEET ITS OBLIGATIONS.**

The responsibility of the NASD is to assure that investors have the necessary facts to make informed investment choices. In addition, representatives must complete a "suitability questionnaire" for each prospective investor before making specific investment recommendations. This questionnaire, kept on file by the brokerage firm, shows the NASD that the individual investor has sufficient net worth to participate in the suggested level of investment risk. **SECURITIES REGULATORS HELP INVESTORS BY REQUIRING FULL DISCLOSURE AND BY IMPOSING SUITABILITY REQUIREMENTS. NO ONE, HOWEVER, CAN STOP SECURITIES FROM FLUCTUATING ACCORDING TO THEIR INHERENT MARKET RISKS.**

SUMMARY

The Securities and Exchange Commission and The National Association of Securities Dealers provide important protection for investors:

- ✓ The prospectus or offering circular discloses all important investment details
- ✓ The NASD regulates and monitors member investment firms and their representatives
- ✓ SIPC insurance guarantees brokerage accounts if a member firm fails

BONDS

WHEN YOU BUY BONDS, YOU LOAN YOUR MONEY TO A CORPORATION, TO A STATE, TO A CITY, OR TO THE FEDERAL GOVERNMENT. Bonds sell in $1,000 increments, although some require a minimum investment of $5,000 or more. Because all bonds pay a fixed interest rate until they mature, they are referred to as fixed-income securities. Fixed-income securities include treasury notes, treasury bills, and treasury bonds. The maturity dates of bonds will be short (one year or less), intermediate (one to ten years), or long (ten to thirty years). A bond purchaser agrees to loan money to the issuer for a certain time period. **DURING THIS 'LOAN' PERIOD, THE ISSUER AGREES TO PAY A FIXED INTEREST RATE FOR THE USE OF THE MONEY. AT MATURITY, THE FULL INVESTMENT OR PRINCIPAL IS RETURNED.**

BONDS HAVE VARYING DEGREES OF RISK BASED UPON THE FINANCIAL STRENGTH OF THE ISSUER. The lower rated bonds pay higher interest. **TWO MAJOR INDEPENDENT AGENCIES THAT RATE THE INVESTMENT QUALITY OF BONDS ARE STANDARD AND POORS AND MOODY'S INVESTOR SERVICES.** After looking at the assets and liabilities of the issuers, they base their rating on the issuer's ability to make the payments as promised. The bond ratings range from prime for the highest grade, to very speculative for the lowest grade. Table 9.1 shows bond ratings.

Table 9.1 BOND RATINGS

Standard & Poors*	Moody's	
AAA	Aaa	Prime or highest grade
AA	Aa	Excellent or high grade
A	A-1, A	Upper medium
BBB	Baa-1, Baa	Medium grade-commercial banks do not invest below this level
BB	BA	Low grade. This level & below are called "junk" bonds
B,CCC	B, Caa	Very speculative

* This rating may include a(+) or a (-) showing the bond in the upper or lower segment of a certain category.

All bonds are subject to an **INTEREST RATE RISK. DISCOUNT BONDS ARE OLDER BONDS WITH LOWER PRICES BECAUSE INTEREST RATES WENT UP AFTER THEY WERE ISSUED.** They sell for under $1,000. An investor who buys bonds at a discount receives the full $1,000 at maturity and pays capital gains on the profit. **BONDS SELLING AT A PREMIUM SELL FOR MORE THAN $1,000. THEY ARE WORTH MORE BECAUSE INTEREST RATES DROPPED AFTER THEY WERE ISSUED.**

**%
Interest**

The face value of bonds fluctuate to balance out rising and falling interest rates

If, for example, an older bond has five years to maturity and pays 6% interest, but the current interest rate for similar bonds is 8%, the older 6% bond could not be sold if it were not "price" discounted. So, to be competitive with the current higher interest rate, the $1,000 par value is reduced. The 6% bond with five years to maturity might sell on the current market for $905.65. For each year to maturity, the older bond is discounted in value to make up for the higher interest on the new bond. An investor who holds the older bond to maturity to claim the full $1,000 value will not make more money because he also lost out on the higher interest. Similarly, when interest rates drop, bonds with higher than market yields become more valuable and sell for a premium (more than their $1,000 par value).

Bonds decrease in value when interest rates rise

SINCE BONDS PAY FIXED INTEREST AND ARE GUARANTEED FOR A CERTAIN TIME PERIOD, AN INVESTOR WHO SELLS BEFORE THE MATURITY DATE CAN MAKE MONEY OR LOSE MONEY ON THE INCREASE OR DECREASE OF THE PAR VALUE. Bonds are extremely vulnerable to the rise and decline in interest rates.

The face value of all bonds at maturity is quoted at $1,000. If interest rates have changed since the bond was issued, the market price will be different. Newspapers quote the market price as a percentage of face value. A bond quoted at 76½ sells for 76½% of $1,000, or $765. A bond quoted at 106¼ sells for 106¼% of $1,000, or $1,062.50. Newspapers also quote the fixed, payable interest rate, such as 9.75% or 7.12%. **THE INTEREST RATE IS BASED ON THE $1,000 MATURITY VALUE (SAME AS PAR VALUE). THE INTEREST RATE WILL DIFFER FROM THE CURRENT YIELD IF YOU PAY MORE OR LESS THAN $1,000 FOR THE BOND.** To calculate the current yield, divide the interest rate by the bond price. For example, a bond purchased for $765 with an interest rate of 5% has a current yield of 6.5%. The 5% interest on $1,000 pays $50. This $50 divided by the price of $765 will also equal the current yield of 6.5%.

Bond quotes show yield and market value

BOND ISSUERS OFTEN PROTECT THEMSELVES AGAINST FALLING INTEREST RATES BY HAVING A RECALL PROVISION. BONDS WITH THIS PROVISION ARE 'CALLABLE.' This allows the issuer to redeem their bonds at the stated price before they mature. Never pay more for a bond than its recall price. **SOME BONDS ARE 'CONVERTIBLE.'** This provision allows the investor to convert the bond to common stock under certain conditions.

A callable bond can be redeemed by the issuer before maturity

A convertible bond can be exchanged for common stock

BEFORE PURCHASING BONDS, ALWAYS CHECK THE RATING, THE MATURITY DATE, AND THE RECALL PROVISION. Also consider if interest rates are expected to rise or decline. Fixed income securities offer steady, safe income, but the principal will decline in value if interest rates rise after the bond is issued. If this happens and you sell before the bond's maturity date, you will lose some of your principal.

IF YOU ARE TAXED HIGH, YOU CAN INCREASE YOUR NET YIELD WITH MUNICIPAL BONDS. Municipal bonds have lower yields, but offer interest free from federal income tax, and free from state income

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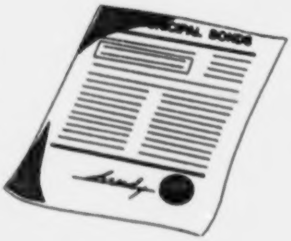


tax in the state where the bond originates. (Remember, federal treasury bonds are exempt from state and local income taxes, but not from federal taxes.) You can buy bonds with tax free federal interest, tax free state interest, or both. A tax free bond could pay 3%, while a taxable bond pays 5%. Look at your tax bracket and the taxable vs. tax free yields to see if tax free income benefits you.

Table 9.2 shows taxable yields needed to match tax free yields for various tax brackets. For example, someone in a 43% tax bracket (36% federal + 7% state) would have to earn a taxable yield of 8.77% to equal the tax free yield of 5%. A choice of 5%, 6%, or 7% for state taxes are added to the 28%, 31%, 36%, and 36.9% federal rates. **FOR HELP IN DETERMINING YOUR TAX BRACKET, SEE THE 1995 FEDERAL TAX RATES AND THE STATE TAX BRACKET CHART IN THE APPENDIX.**

TAX — FREE INVESTMENTS
TRIPLICATES

Table 9.2 TAXABLE VS. TAX FREE YIELDS

Find the line of the tax free yield. Then find the column showing your tax bracket. The intersecting taxable yield will show what you would need to earn to make up for the taxes saved on a tax free investment.

TAX BRACKET	28% Federal Only	33% Fed. +5% State	34% Fed. +6% State	35% Fed. +7% State
Tax Free Yield	Taxable Yield Needed To Equal Tax Free Yield			
3.0%	4.17%	4.48%	4.55%	4.62%
3.5%	4.86%	5.22%	5.30%	5.39%
4.0%	5.56%	5.97%	6.06%	6.15%
4.5%	6.25%	6.72%	6.82%	6.92%
5.0%	6.94%	7.46%	7.58%	7.69%
5.5%	7.64%	8.21%	8.33%	8.46%
6.0%	8.33%	8.96%	9.09%	9.23%
6.5%	9.03%	9.70%	9.85%	10.00%
7.0%	9.72%	10.45%	10.61%	10.77%

Table 9.2 TAXABLE VS. TAX FREE YIELDS (continued)

TAX BRACKET	31% Federal Only	36% Fed.+5% State	37% Fed. +6% State	38% Fed. +7% State
Tax Free Yield	**Taxable Yield Needed To Equal Tax Free Yield**			
3.0%	4.35%	4.69%	4.76%	4.84%
3.5%	5.07%	5.47%	5.56%	5.65%
4.0%	5.80%	6.25%	6.35%	6.45%
4.5%	6.52%	7.03%	7.14%	7.26%
5.0%	7.25%	7.81%	7.94%	8.07%
5.5%	7.97%	8.59%	8.73%	8.87%
6.0%	8.70%	9.38%	9.52%	9.68%
6.5%	9.42%	10.16%	10.32%	10.48%
7.0%	10.14%	10.94%	11.11%	11.29%

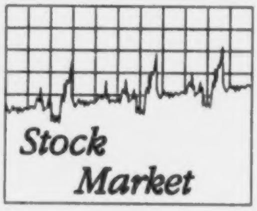
TAX BRACKET	36% Federal Only	41% Fed.+5% State	42% Fed. +6% State	43% Fed. +7% State
Tax Free Yield	**Taxable Yield Needed To Equal Tax Free Yield**			
3.0%	4.69%	5.09%	5.17%	5.26%
3.5%	5.47%	5.93%	6.03%	6.14%
4.0%	6.25%	6.78%	6.90%	7.02%
4.5%	7.03%	7.63%	7.76%	7.90%
5.0%	7.81%	8.48%	8.62%	8.77%
5.5%	8.59%	9.32%	9.48%	9.65%
6.0%	9.38%	10.17%	10.35%	10.53%
6.5%	10.16%	11.02%	11.21%	11.40%
7.0%	10.94%	11.86%	12.07%	12.28%

Table 9.2 TAXABLE VS. TAX FREE YIELDS (continued)

TAX BRACKET	**39.6%** **Federal Only**	**44.6%** **Fed.+5% State**	**45.6%** **Fed. +6% State**	**46.6%** **Fed. +7% State**
Tax Free Yield	**Taxable Yield Needed To Equal Tax Free Yield**			
3.0%	4.97%	5.42%	5.51%	5.62%
3.5%	5.80%	6.32%	6.43%	6.55%
4.0%	6.62%	7.22%	7.35%	7.49%
4.5%	7.45%	8.12%	8.27%	8.43%
5.0%	8.28%	9.03%	9.19%	9.36%
5.5%	9.11%	9.93%	10.11%	10.30%
6.0%	9.93%	10.83%	11.03%	11.24%
6.5%	10.76%	11.73%	11.95%	12.17%
7.0%	11.59%	12.64%	12.87%	13.11%

You can purchase **INDIVIDUAL BONDS** through a broker or a large portfolio of bonds through a mutual fund. Most mutual fund families have several **BOND FUNDS**. Some specialize in the higher income from lower rated bonds, some have only investment grade issues, some only include government securities, and some offer tax exempt income. **REMEMBER THAT INCOME IS THE PRIMARY PURPOSE FOR A BOND INVESTMENT.** With this criteria, an investment under $10,000 makes little sense since smaller amounts generate little income.

STOCKS



WHEN YOU BUY BONDS, YOU LOAN YOUR MONEY, BUT WHEN YOU PURCHASE STOCKS, YOU BECOME A PART OWNER IN THAT COMPANY. Most companies raise the initial capital needed to start their business by selling stock. After the original funding, the stock of profitable companies increases in demand. The price goes up and shares become more valuable when investors are willing to pay more for the stock. If a company experiences losses, the stock declines in value. Should the company go out of business, the stock can even become worthless.

Earnings

AS A RULE, A COMPANY'S EARNINGS AND ITS GROWTH POTENTIAL CONTROL THE DEMAND FOR ITS STOCK. When a company has a bright future, more people want to buy in, so the shares increase in value. In contrast, when demand is low and buyers are few, the price falls.

You make money owning stock when you receive dividends and when the price per share goes up. BECAUSE INDIVIDUAL STOCKS HAVE THE POTENTIAL OF INCREASING IN VALUE AS WELL AS PAYING DIVIDENDS, STOCKS ATTRACT MANY INVESTORS.

Stock pays investors through dividends and increases in price per share

Consider both dividends and increases in the stock's value to calculate your total yield. For example, assume you purchased 100 shares of XYZ's stock at $80 a share ($8,000). It yields 5%, so pays an annual dividend of $4 a share, or $400 total. The dividend per share divided by the price per share gives the stock's yield ($4 divided by 80 = 5%).

Consider both dividends and increases in the stock's value to calculate total profits

After five years of holding this stock, you sell it for $105 a share, or $10,500 total. You've made $2,500 (the $10,500 sales price minus the $8,000 purchase price equals the capital gain of $2,500). Your total return, however, needs to consider the dividends as well as the capital gain. Assuming this stock paid a steady 5% dividend for five years, you would have received $2,000 in dividends ($400 x 5 years = $2,000). The total dividends received, $2,000, added to the $2,500 capital gain shows a profit of $4,500 on this $8,000 investment during the five year holding period. Therefore, your total yield is 56% or 11.25% per year ($4,500 divided by $8,000 = 56%; 56% divided by 5 years = 11.25% per year). Brokerage commissions, not considered here, reduce the yield slightly.

EACH TYPE OF STOCK HAS A DIFFERENT OBJECTIVE. SOME PAY HIGH DIVIDENDS WHILE OTHERS EMPHASIZE GROWTH. IF THE STOCK DOESN'T MATCH YOUR NEEDS, YOU WON'T BE HAPPY WITH YOUR INVESTMENT.

Each type of stock has a different objective

Companies issue both preferred and common stock. COMMON STOCK HAS MANY CATEGORIES OF GROWTH AND INCOME, SUCH AS HIGH INCOME AND LOW GROWTH, MEDIUM INCOME AND MEDIUM GROWTH, OR LOW INCOME AND AGGRESSIVE GROWTH. PREFERRED STOCK PAYS STEADY DIVIDENDS LIKE BONDS. Preferred stock makes payments regardless of the company's profitability, but usually has a lower yield and less security than bonds. Unlike common stock, it does not participate in the company's growth. Preferred stock, however, can offer provisions permitting it to be converted to common stock. If it can not be converted, a bond or common stock probably will serve your needs better.

BLUE CHIP STOCK IS FROM THE LARGE, STABLE CORPORATIONS LIKE COCA-COLA, MCDONALDS, PROCTOR AND GAMBLE, AND EXXON. FOR THE MOST PART, THEIR CONSISTENT EARNINGS ALLOW THEM TO PAY STEADY DIVIDENDS TO THEIR

Blue chip stock is a good investment for income

STOCKHOLDERS. Normally, blue chip stock is a good investment for income. Sometimes, unexpected market situations or new inventions will affect profits and likewise the dividends paid, but as a rule most blue chip companies are dependable performers.

At the other end of the spectrum are the smaller, lesser known companies. Their stock costs less than the higher priced blue chip. **THESE COMIPANIES EXPAND BY REINVESTING MOST OF THEIR PROFIT BACK INTO THE COMPANY, SO THEIR STOCK IS CALLED GROWTH STOCK. GROWTH STOCK HAS MORE RISK BECAUSE THE COMPANY'S FUTURE IS UNKNOWN.** Many people, however, have made a lot of money from buying in on a new company with potential while the price was still low.

The blue chip companies all started small and became successful through solid management and a popular product line. The same can happen to other small, well-managed companies with increasing demands for their product or service. If a person succeeds in buying stock in the right company when the price is low, and holds the shares until the company's earnings grow, he or she can double the original investment many times over.

Selecting the right stock takes expertise, research, and a sense for future needs

To illustrate the potential profits of growth stocks, look at the three examples below showing what $10,000 invested on December 31, 1934 grew to by December 31, 1994. These examples assume that **ALL DIVIDENDS WERE TAKEN IN CASH AND NOT REINVESTED** to buy more shares.[10]

	Value January 1, 1934	Value December 31, 1994
Philip Morris	$10,000	$1,842,397
Proctor & Gamble	$10,000	$1,526,152
General Electric	$10,000	$1,255,386

THOUSANDS OF ANALYSTS WORK FOR VARIOUS INVESTMENT FIRMS STUDYING EMERGING NEW COMPANIES AND HOPING TO PICK A "SLEEPING GIANT," OR AT SECOND BEST, A SUCCESSFUL PERFORMER. Selecting the right company takes expertise, research, and a sense for what business will be like in the future. Investments in growth stocks are exciting when you win, but equally devastating when the company fails and your investment shrinks. But, if you pick just one big winner, it can make up for losses on other purchases. For many, playing the stock market and selecting the right company is a numbers game. They know if they succeed just 55% of the time they will make money.

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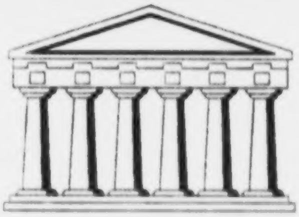

STOCKS CAN ONLY BE BOUGHT OR SOLD BY SECURITIES BROKERS. THE AMERICAN STOCK EXCHANGE AND THE NEW YORK STOCK EXCHANGE ARE REFERRED TO AS THE 'BIG BOARDS.' THEY TRADE THE LISTED STOCK FROM LARGE COMPANIES. The **NASDAQ** or National Association of Securities Dealers of Automated Quotations have an automated information network where they trade the smaller, lesser known companies. The NASDAQ is also known as the **OVER-THE-COUNTER MARKET.** The closing price per share for the previous day's trades from these three exchanges are listed daily in most newspapers.

MUTUAL FUNDS

Unless you have enough money to buy a variety of stocks and bonds, along with the time and expertise to select and manage them, consider mutual funds. **MUTUAL FUNDS ARE MANAGED BY INVESTMENT COMPANIES THAT COMBINE MONEY FROM MANY INVESTORS TO BUY A WIDE SELECTION OF SECURITIES TO MEET SPECIFIC OBJECTIVES.**

Mutual funds make sense for investors who don't have the time, money, or expertise to select a variety in their portfolio

MUTUAL FUND INVESTORS ARE CALLED SHAREHOLDERS SINCE THEY PURCHASE SHARES OF A FUND. EACH SHARE REPRESENTS OWNERSHIP IN HUNDREDS OF COMPANIES. The price of mutual fund shares change as the securities within the portfolio rise and fall with the current market. If the price per share were $10, $1,000 would buy 100 shares.

MOST COMPANIES HAVE A FAMILY OF FUNDS, THAT IS, SEPARATE FUNDS WITH DIFFERENT OBJECTIVES UNDER THE SAME ROOF. EACH FUND HAS A PROFESSIONAL MANAGER OR GROUP OF MANAGERS WHO TAKE CHARGE OF THAT FUND'S PORTFOLIO. Fund managers purchase stocks, bonds, or money market investments. They watch the market and buy or sell as needed to get the highest possible return for shareholders while adhering to the overall objective of the fund. Through mutual funds, investors benefit from the expertise of professional management for a nominal fee.

Through mutual funds, investors benefit from the expertise of professional managers for a nominal fee

Fees and Charges

All funds have expenses and fees, and some have sales charges. These fees and charges must be fully disclosed in the prospectus. Sales charges go to the securities brokers and their

All fees and charges must be disclosed in the prospectus

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representatives for selling the fund. Often their advice and continued service make the fee worthwhile. Good investment advice can save you far more than what you pay for a sales charge.

Funds with sales charges are called "load" funds. If it is a front-end load, you buy in at the offering price, which will be higher than the fund's net asset value (NAV) per share. For example, if the newspaper lists the offering price of the fund as 10.00 and the NAV as 9.55, the sales charge is 4.5%. An investor must buy in at the higher price and sell at the lower price.

Load funds have an offering price higher than their net asset value or redemption price

The maximum sales charge allowed is 8.5%. Most funds today, however, have reduced their sales charges to the 3% to 6% range. You only pay a sales charge once. Thereafter, you can move your money from one fund to another within the same family with no additional charge. **MUTUAL FUNDS WITH FRONT-END SALES CHARGES ARE ALSO REFERRED TO AS 'A' SHARES.**

Some funds have no initial sales charge, but have a redemption fee that lasts for a specified time period. **THESE BACK-END LOADS ARE CALLED 'B' SHARES BY FUND COMPANIES.** A redemption fee discourages investors from buying into a fund then selling after a short hold. **AN 'R' NEXT TO A FUND LISTED IN THE PAPER, OR A REFERENCE TO 'B' SHARES, INDICATES A BACK-END LOAD. IT IS POSSIBLE TO BUY EITHER 'A' OR 'B' SHARES OF THE SAME FUND.** To make this decision, consider your projected holding period and the fund's expenses for both class "A" and class "B" shares.

Some funds have a redemption fee charged upon selling

The paper lists **NO LOAD FUNDS** with a quote for the NAV and an "NL" for the offering price. Given equal performance and equal fee schedules, you will come out ahead with no load funds. With a no load fund, however, you are your own adviser and must do your own research to keep tabs on the fund's performance.

The so-called load funds, which include both class "A" and class "B" shares, pay the sales charge to brokers and representatives for selling the fund. The no load funds usually spend an equal amount of their fund's profits, but choose to put their money into advertising instead of paying salespersons. So, no load funds spend money on advertising in popular magazines and newsletters, while load funds depend on representatives to distribute their shares. One way or another, funds pay for the distribution of their shares out of the fund's profits. **THE FUND'S PERFORMANCE AND THE NET RETURN TO INVESTORS SHOULD BE A MORE IMPORTANT CONSIDERATION THAN HOW THE FUND CHOOSES TO DO ITS ADVERTISING.**

MAGAZINE
DAILY NEWS

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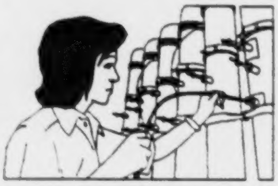
All funds charge annual management and expense fees. These generally range from .2% to 1% of the net assets of the fund. Funds subtract these expenses before calculating the profits for investors. **THE PROSPECTUS DISCLOSES ALL FEES AND EXPENSES UNDER ANNUAL FUND OPERATING EXPENSES.**

All funds charge annual management and expense fees ranging from .2% to 1%



Study a fund's past performance before you invest. Look at the preceding year, the preceding five years, and the preceding ten years. Mutual fund information can be found in publications such as *Money*, *Mutual Fund Magazine*, *Business Week*, *Fortune*, *Changing Times*, *Forbes*, *Barons*, *Investors Daily*, and *The Wall Street Journal*. Keep in mind that many magazines are biased and print biased studies and articles because they receive huge advertising revenues from many fund companies.

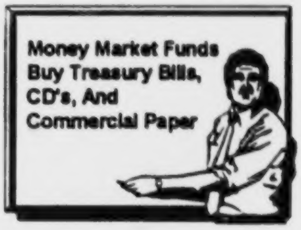
TO LOOK UP DETAILED, UNBIASED INFORMATION WITH ARTICLES AND SURVEYS NOT INFLUENCED BY PROMOTERS, TWO EXCELLENT REFERENCE BOOKS ARE AVAILABLE: *WEISENBERGER INVESTMENT SERVICES* AND *MORNINGSTAR*. MOST LIBRARIES HAVE COPIES. Both of these reference books rate ALL funds according to performance in their category. They also analyze the fund's portfolio, its management, and its risk level. They provide a valuable service, especially when considering the 5,000 plus mutual funds available today.

An unbiased ranking of funds by performance is done by *Morningstar* and *Weisenberger*

Fund Objectives

MOST MUTUAL FUND FAMILIES HAVE MONEY MARKET FUNDS, INCOME FUNDS, GROWTH & INCOME FUNDS, AND GROWTH FUNDS. Many also have **GLOBAL FUNDS,** which invest worldwide, and/or **SPECIALTY FUNDS.** The prospectus outlines a fund's objective, its current portfolio (its investment holdings), and other important information. Portfolio managers select securities to meet the objective of the fund. To be happy with a fund, you must match its purpose to your own. **LET'S LOOK AT THE COMMON INVESTMENTS SELECTED BY FUND MANAGERS TO MEET DIFFERENT OBJECTIVES.** All funds can keep a certain percentage of their assets in cash.

- ◆ **OBJECTIVE:** *Liquidity with Highest Possible Yield.* **MONEY MARKET FUNDS** buy short-term money investments such as treasury bills, certificates of deposit, or commercial paper issued by corporations. These funds have check writing privileges and their interest rate changes daily. Money market funds do not have sales charges, even those under the umbrella of "load" funds.


Money Market Funds Buy Treasury Bills, CD's, And Commercial Paper

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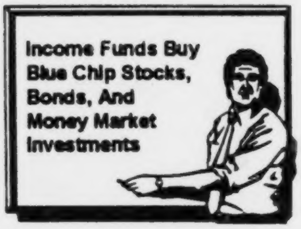
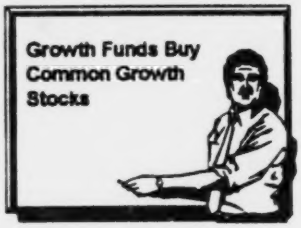
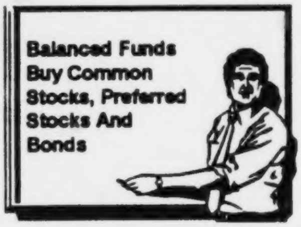
◆ **OBJECTIVE:** *High Yield & Preservation of Capital.* Generally, **INCOME FUNDS** hold various grades of bonds that pay interest. The higher yielding income funds often have lower grade bonds in their portfolio. **EQUITY INCOME FUNDS** buy blue chip stocks that pay consistent dividends.



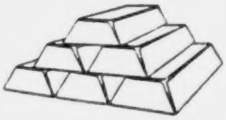
◆ **OBJECTIVE:** *Growth & Maximum Capital Gains.* **GROWTH FUNDS** primarily select common growth stocks. The more aggressive funds naturally select more aggressive stocks, from young, growing companies. In growth funds, the dividends are small, but as the stock held by the portfolio grows in value, the share prices of the fund also increase. Some managers sell often to take the profits or capital gains from these stocks and reinvest them. How often the manager sells shows the turnover of the portfolio. Some managers believe in buying quality and holding, others believe in taking profits often and reinvesting.



◆ **OBJECTIVE:** *Growth & Income.* Funds seeking **GROWTH AND INCOME** might invest in both blue chip and growth stocks. **BALANCED FUNDS** promote long-term growth plus income, so they hold bonds, preferred stock, and common stock. Although growth and income funds and balanced funds usually have less growth than the growth funds, and less income than the income funds, they deliver the important combination of steady growth combined with regular income. Many have excellent long-term track records. Many of these funds tend to hold their value during down markets.



SOME FUNDS GET MORE SPECIALIZED THAN JUST GROWTH AND INCOME. For example, they can produce income only from utility stocks, or tax free income from municipal bonds. **MANY FAMILIES HAVE FEDERALLY INSURED FUNDS THAT PURCHASE ONLY GOVERNMENT SECURITIES.** Other choices include **GOLD FUNDS**, or funds in other precious metals. Some growth funds can buy only **AMERICAN STOCKS**, while others participate in the **WORLD ECONOMY**. Many global funds that invest worldwide have been added to typical U.S. fund families during the past five years. **SOMETIMES A FUND CAN SPECIALIZE IN A PARTICULAR INDUSTRY SUCH AS COMMUNICATIONS OR HEALTH CARE.** Some funds are **ENVIRONMENTALLY AWARE** and will only buy stock of companies that do not harm the environment. By purchasing these funds, you can also make a political statement. Chances are any investment offered to the public can also be purchased through a mutual fund.



REITS buy real estate in a mutual fund

Another feature of mutual funds are Real Estate Investment Trusts or **REITS**. REITS operate like mutual funds but own various real estate investments instead of stocks and bonds. REITS are traded on the stock exchanges. **ALTHOUGH REAL ESTATE INVESTMENTS ARE NOT LIQUID, WELL-SELECTED REAL ESTATE HAS KEPT UP WITH INFLATION. REITS OFFER LIQUIDITY COMBINED WITH WELL-SELECTED REAL ESTATE AS THEIR PRIMARY BENEFIT. BEFORE PURCHASING, LOOK CAREFULLY AT THE FEES AND CHARGES BECAUSE THEY ARE USUALLY HIGHER THAN OTHER INVESTMENTS.**

For complete information, always check a fund's portfolio in the prospectus and look at how the money is invested. Also look at the fund objective, its risk level, its ratings in both up and down markets, and its past performance in Morningstar or Weisenberger. This gives you a good idea of what to expect for future performance. **ALTHOUGH PAST PERFORMANCE DOES NOT INDICATE FUTURE SUCCESS, IT IS THE BEST SINGLE INDICATOR AVAILABLE.**

Dollar Cost Averaging

DOLLAR COST AVERAGING IS A METHOD OF INVESTING THAT TAKES ADVANTAGE OF MARKET SWINGS. It is often difficult for investors to determine the best time to invest a large sum of money, especially when the market is high. If the market dips soon after your purchase, the value of your investment will drop. If you buy at a lower price you can buy more shares.

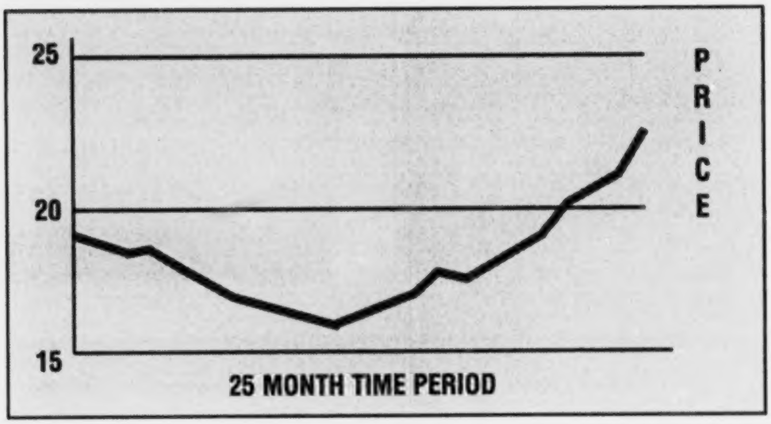
For example:

$10,000 invested in a mutual fund at $19 per share purchases 526.32 shares. Should the price per share drop to $16 over the next year those 526.32 shares are now worth $8,421 (526.32 x $16 = $8,421). If you invested $10,000 at $16 per share, you would purchase 625 shares. Then when the price rises, you have more shares increasing in value. If these 625 shares increase in value to $19, your fund would be worth $11,875 (625 x $19 = $11,875).

Dollar cost averaging takes advantage of investing at various market prices and eliminates the guesswork. With dollar cost averaging, instead of investing one lump sum, you would invest the same amount over time, such as $400 per month for 25 months ($400 x 25 = $10,000).

The following graph shows the price fluctuations of a hypothetical mutual fund over a 25 month period where the market declines and then rises. It starts at $19 per share, drops to $16, then recovers and rises to $23 per share by the 25th month.

The best time to invest would be when the share price is at the low of $16, approximately the 12th month. Accurately guessing a "low" is difficult, although some try by studying the fund's



price fluctuations during different market conditions. The best alternative to reduce the risk of buying "high" is **DOLLAR COST AVERAGING**. Investing $400 per month over 25 months has the following results:

Table 9.3 DOLLAR COST AVERAGING

Price Per Share	Shares Purchased
19.00	21.05
18.70	21.39
18.60	21.51
18.50	21.62
18.00	22.22
17.50	22.86
17.30	23.12
17.00	23.53
16.80	23.81
16.50	24.24
16.20	24.69
16.00	25.00
16.40	24.39
16.80	23.81
17.00	23.53
17.50	22.85
17.70	22.60
18.00	22.22
18.50	21.62
19.00	21.05
20.00	20.00
20.50	19.51
21.00	19.05
22.00	18.18
23.00	17.39

Shares Purchased = 551.24
Amount Invested = $10,000 over 25 months
Value at end of 25 months @ $23 per share is $12,679

The results of investing at $19 per share, $16 per share, and using dollar cost averaging are as follows:

AMOUNT INVESTED	METHOD USED	PRICE PER SHARE AT PURCHASE	SHARES BOUGHT	VALUE OF SHARES AT $23
$10,000	LUMP SUM	19.00	526.32	$12,105
$10,000	LUMP SUM	16.00	625.00	$14,375
$10,000	AVERAGING	VARIOUS	551.24	$12,678

Note: In this example, the price dropped steadily before it increased. Dollar cost averaging is not advantageous if the price per share steadily increases without a decline.

Dollar cost averaging eliminates the guesswork and reduces your risk by buying shares at various market prices. Usually, longer time periods show better results than short periods.

Special Features

IF YOU PLAN TO INVEST LARGE AMOUNTS OF MONEY INTO A LOAD FUND, YOU CAN QUALIFY FOR A BREAKPOINT, OR REDUCED SALES CHARGE. The first reduction for most funds is at $50,000, and will be explained fully in the prospectus. Funds also offer a letter of intent. This means if you, or members of your immediate family, intend to purchase additional shares during the coming year, you can sign this letter and qualify for the reduced sales charge. All purchases made within one fund family count toward the breakpoint.

Breakpoints allow for reduced sales charges on large purchases

YOU CAN REDEEM MUTUAL FUND SHARES AT ANY TIME. Most newspapers list the value of mutual fund shares daily. The number of shares times the net asset value tells how much money you will receive if you liquidate. If you own 400 shares with a net asset value of $8 a share, you would receive $3,200 (400 x $8 = $3,200). When a fund receives a "redemption request," they mail a check within five business days.

Shares are redeemed at their net asset value within five business days

To redeem shares, most funds offer a telephone redemption if you request this on the original application. Otherwise a written request is needed and it will need your signature guarantee. This can only be done by a commercial bank or stock brokerage firm. A word of caution here: credit unions and savings and loans cannot guarantee signatures unless they work with a commercial bank. If you invest in mutual funds, make sure you can easily get a signature guarantee, or request telephone exchange privileges.

Two basic types of funds exist: **OPEN-END FUNDS** and **CLOSED-END FUNDS.** Most of the funds on the market are the open-end type. They have no limit on the number of shares the fund can own; they are open to new investments, and shares can be redeemed at any time.

Unlike the open-end funds, the closed-end funds have a limit on the amount of money they can take in. **ONCE AN OFFERING FOR A CLOSED-END FUND CLOSES, NEW INVESTORS CANNOT PARTICIPATE IN THAT FUND.** Shares of closed-end funds are traded like shares of stock; buyers decide the price they are willing to pay to purchase a seller's shares. Commissioned brokers complete these trades.

Advantages of Mutual Funds for Small Investors

◆ Without a doubt, mutual funds have numerous advantages for small investors. **MANY MUTUAL FUND FAMILIES HAVE SMALL INITIAL INVESTMENTS RANGING FROM \$100 TO \$1,000, AND ACCEPT ONGOING DEPOSITS OF \$25 OR MORE.** Some have no minimum.

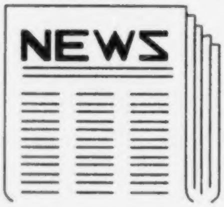
◆ **ANOTHER MAJOR ADVANTAGE IS DIVERSIFICATION, WHICH NORMALLY ISN'T POSSIBLE WITHOUT LARGE AMOUNTS OF MONEY TO INVEST.** The fund concept allows an individual to invest in a broad range of securities for a small amount of money. As already mentioned, diversification reduces risk by spreading the investment dollars among numerous companies and/or industries. This allows an investor to have variety in a small portfolio without paying excessive commissions and sales charges. Diversification, an important key for successful investing, is automatic with mutual funds.

Diversification reduces risk by spreading your investment dollars among numerous investments

◆ **PROFESSIONAL MANAGEMENT IS ANOTHER IMPORTANT FEATURE OF MUTUAL FUNDS.** Shareholders benefit from the expertise of the fund manager or group of managers who continually watch the market for advantageous times to trade the securities in the portfolio. The shareholder's money participates in all this activity for a small annual management fee assessed by the fund.

◆ **LIQUIDITY IS AN IMPORTANT FEATURE OF MUTUAL FUNDS.** Funds offer several convenient ways to liquidate their shares. They will send you a check monthly or quarterly: 1) for the dividends, 2) for the dividends and capital gains, or 3) for a specified amount. When this option is requested, and the dividends and capital gains aren't enough, they sell enough shares to cover the amount.

◆ **WITH A MUTUAL FUND YOU DON'T HAVE TO GUESS AT YOUR INVESTMENT'S PROGRESS;** newspapers give the preceding day's closing price. In addition, fund families keep shareholders well informed. They send updates to the prospectus and annual reports to all shareholders for each fund owned. They also mail statements each time an account has a transaction, such as shares purchased, shares redeemed, and dividends or capital gains paid. These regular statements make additional investments in a fund easy because they include a payment voucher to mail in with a check.



◆ **EXCHANGE PRIVILEGES ALLOW AN INVESTOR TO MOVE MONEY FROM ONE FUND TO ANOTHER WITHIN THE SAME FAMILY WITH NO ADDITIONAL SALES CHARGE.** This feature provides great flexibility. If an investor's financial objective changes due to retirement, an increase in assets, an unexpected illness, or other reasons, he or she can easily move money to another fund, or divide it among several funds at no cost. Switching funds within a family is easy, especially since most companies allow exchanges by telephone.

Fund families offer exchange privileges

Advantages of Mutual Fund Investments:
✓ **Small Initial Investment**
✓ **Diversification**
✓ **Professional Management**
✓ **Liquidity**
✓ **Convenience & Current Information**
✓ **Exchange Privileges**

LIMITED PARTNERSHIPS

LIMITED PARTNERSHIPS, LIKE MUTUAL FUNDS, WORK WITH THE COMBINED MONEY OF MANY INVESTORS. Here, the general partner forms the partnership, purchases the investment, and takes responsibility for the daily management. Real estate is a common limited partnership investment. **THE POOLED MONEY OFTEN BUYS APARTMENT UNITS, MINI-WAREHOUSES, SHOPPING CENTERS, AND COMMERCIAL BUILDINGS. GENERAL PARTNERS, HOWEVER, PUT TOGETHER MANY INVESTMENTS OTHER THAN REAL ESTATE HOLDINGS AND SELL THEM AS LIMITED PARTNERSHIPS.** Some common ones are: movie rights, oil and gas wells (either exploratory or income producing), equipment purchases and leases, and mortgage pools.

The general partner forms the partnership, raises the money, purchases the investment, and takes responsibility for the management

LIMITED PARTNERSHIPS ARE NOT TRADED LIKE STOCKS AND MUTUAL FUNDS ON THE OPEN MARKET SO THEY ARE NOT LIQUID, UNLESS THE GENERAL PARTNER AGREES TO PURCHASE UNITS BACK FROM INVESTORS. The original investment plus profits (minus fees and charges) are returned when the general partner sells the investment. Some limited partnerships purchase income producing investments to create an ongoing annual cash flow to the partnership.

Most partnerships are not liquid

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The benefits of ownership pass through to the limited partners

THE BENEFITS OF OWNERSHIP PASS THROUGH TO THE LIMITED PARTNERS. When the investment sells or earns income, the general partner and the limited partners divide the profits; limited partners usually receive 75% to 85% of the proceeds, the general partner receives the rest.

Partnership income and losses are passive

The 1986 Tax Reform Act drastically changed limited partnerships. Formerly, the depreciation from equipment and commercial buildings generated tax write-offs for the investor. Now, a subscriber cannot write off more than their initial investment. Furthermore, partners who do not participate in the management of the partnership cannot deduct depreciation and other expenses. These write-offs are now *passive* and can only offset *passive income* from the partnership.

PARTNERSHIPS TAKE ONE OF TWO FORMS: PRIVATE PLACEMENTS OR REGISTERED PUBLIC OFFERINGS. A private placement can have no more than thirty-five investors. They are limited to raise smaller amounts of money. **TYPICALLY, PRIVATE PLACEMENTS ARE FOR EXPERIENCED INVESTORS WHO OFTEN INVEST $25,000 OR MORE.** Although these partnerships are not registered with the SEC, the offering circular must make full disclosure of all facts regarding the investment.

A REGISTERED OFFERING IS MUCH LARGER, OFTEN RAISING MILLIONS OF DOLLARS FROM THOUSANDS OF INVESTORS. It is registered with the SEC and sold as a security. Only qualified registered representatives can sell the shares. The cover of the prospectus states the maximum amount of money the general partner can raise. Once the general partner collects sufficient funds to purchase the assets, they form the partnership and close the offering.

All investors must meet certain suitability standards to invest. Minimum investments are usually $2,000 to $5,000 per unit for registered offerings. **AT TAX TIME, THE GENERAL PARTNER DISTRIBUTES A FORM K-1 TO ALL SUBSCRIBERS SHOWING THEIR PROPORTIONAL SHARE OF PARTNERSHIP INCOME AND EXPENSES. AGAIN, THE PROSPECTUS STATES THE OBJECTIVE OF THE PARTNERSHIP.** In growth partnerships, as in growth stocks, the future of the investment is unknown, so they assume more risk than income partnerships.

BEFORE INVESTING IN A LIMITED PARTNERSHIP, BE SURE TO CONSIDER THE FOLLOWING:

- ✓ The projected length of the partnership.
- ✓ After raising the required funds, how long does the general partner have to invest the money?
- ✓ If the general partner does not invest all the money, what happens to the remainder? Does it stay in the partnership as reserve cash, or is it returned to the partners?

- ✓ How often does the general partner communicate with the limited partners to inform them about the progress of their investment?

- ✓ Do distributions come from actual earnings, from earnings plus a return of capital, or from a return of capital only? Sometimes annual distributions include a portion of the money that limited partners originally invested.

- ✓ Are the limited partners liable for further assessments should the partnership be sued or something go wrong?

- ✓ How much do the limited partners give up for management fees, sales charges, and profits to the general partner?

WINNING WITH INVESTMENTS

WHEN YOU OWN EQUITIES, YOU BECOME AN OWNER OF AN ASSET THAT YOU EXPECT TO INCREASE IN VALUE. Investments can help your money stay ahead of inflation and make up for the amount given up for taxes. A minimum investment goal should be to earn at least a net 2% each year. See "Break-Even Rate of Return" (Chapter 16, *Planning*). Your net yield depends on investment performance after subtracting sales charges, management fees, expenses, and other costs. **YOU ALSO NEED TO CONSIDER THE PORTION OF YOUR PROFIT GIVEN TO TAXES AND THE LOSS OF BUYING POWER DUE TO INFLATION.** If the inflation rate is 4% and you earn only 4% on your taxable savings account, you have only kept even. You have not moved ahead. Once you give up another 30% to taxes, you are behind.

Your net profit depends on investment performance after subtracting:

- **Sales charges**
- **Management fees**
- **Inflation**
- **Taxes**

With investments, you can expect higher yields than with fixed, guaranteed accounts. But remember, no investment program is foolproof. **IT IS THE NATURE OF INVESTMENTS TO FLUCTUATE. "LOSERS" ARE NECESSARY TO HAVE "WINNERS." MOST IMPORTANTLY, WHAT HAS PROVEN TRUE IN THE PAST, MIGHT NOT WORK IN THE FUTURE.** The unpredictable often happens, and when it does, indicators are off. Market conditions always change, and as they do, they will influence the value of your investment.

Investments are not foolproof–
Losers are needed to have winners.

ANYTIME YOU TAKE A CHANCE WITH HIGHER YIELDS, YOU WILL ALSO EXPERIENCE GREATER RISKS. YOU DON'T NEED TO BE OVERLY CONCERNED ABOUT MARKET DIPS IF YOUR LONG-TERM PROFITS KEEP GOING UP. MANY STOCKS

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AND GROWTH MUTUAL FUNDS SHOW SUBSTANTIAL GAINS DURING ANY FIVE YEAR PERIOD, YET OFTEN SHOW LOSSES DURING SHORTER TIME PERIODS.

To Make Money
Buy Low and
Sell High

If you buy stock or mutual funds when the price is low and sell when the price is high, you will always make money. Novice investors often do just the opposite; they jump into the market when everyone else talks about gains and high profits, and then sell when prices are low.

Following the crowd is undependable and ill advised. The best buying opportunity comes when everyone else is selling. If you watch general trends, develop a long-term investment strategy, take only comfortable risk, and trust your instincts, you can win with investments. Investments, although unpredictable, are not overly complicated. Many experts make investing seem complicated by trying to predict the future. Some have good results, others do not. It is impossible to predict the unpredictable consistently with 100% accuracy. To be a successful investor, you must be willing to live with market ups and downs. Look at your long-term goals and your long-term growth opportunities.

The cost of goods & services keep rising, so advancing financially requires earning higher than average yields

Wouldn't it be ideal if we could build sizable estates using only disciplined savings in fixed, guaranteed accounts? Inflation and taxes makes that ideal impossible. Since the cost of goods and services keep rising, and the tax on profits keeps going up, advancing financially requires earning higher than average rates of return. WHEN YOUR EARNINGS DON'T EXCEED THE ONGOING RISE IN THE COST OF SUCH ITEMS AS FOOD, SHELTER, EDUCATION, AND TRANSPORTATION, AT BEST YOU CAN ONLY KEEP ABREAST, BUT CANNOT GET AHEAD. MAKING HEADWAY IN FINANCES TODAY REQUIRES OWNERSHIP, IN ONE WAY OR ANOTHER, IN INVESTMENTS THAT WILL BEAT INFLATION.

Advancing financially in the 1990s is similar to a predicament faced by Alice in Lewis Carroll's *Through The Looking Glass.*

> ALICE FOUND HERSELF IN A STRANGE COUNTRY THAT SHE WANTED TO LEAVE, BUT COULDN'T. SHE TRIED RUNNING AWAY, BUT IT DIDN'T WORK BECAUSE SHE COULDN'T MOVE FORWARD. EVEN WHEN SHE RAN AS FAST AS SHE COULD, SHE WENT NOWHERE. THE QUEEN YELLED AT HER TO RUN FASTER AND FASTER, BUT SHE WAS ALREADY RUNNING AS FAST AS POSSIBLE. ALICE DIDN'T UNDERSTAND THE PROBLEM UNTIL THE QUEEN EXPLAINED THAT THE WORLD WAS MOVING AT THE SAME PACE. SHE SAID:
>
> ... HERE YOU SEE, IT TAKES ALL THE RUNNING YOU CAN DO TO KEEP IN THE SAME PLACE. IF YOU WANT TO GET SOMEWHERE ELSE, YOU MUST RUN AT LEAST TWICE AS FAST..."[17]

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CHAPTER 9 Investments

In our world, prices, wages, earnings, and taxes are all accelerating. We can deplete our resources just trying to stay even. **TO GET AHEAD, WE MUST BEAT THE AVERAGE INCREASES.** We also have to take the queen's advice and "run twice as fast" to make any progress.

Our free enterprise system created rising prices and the inflation problem, but it also created a workable solution. That solution lies in the many investments available today that didn't exist fifty years ago. **THIS WIDE RANGE OF INVESTMENT CHOICES OFFERING MORE FLEXIBILITY AND DIVERSITY CAN HELP US OFFSET THOSE RISING PRICES AND TAX INCREASES WITH INCREASED PROFITS.**

Chapter 10

Home Ownership

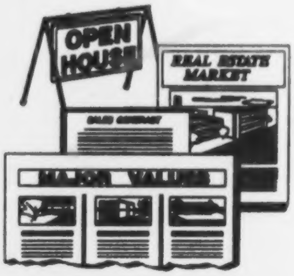
PURCHASING A HOME CAN BE A WISE INVESTMENT. IF REAL ESTATE APPRECIATES AT A HEALTHY RATE IN THE AREA WHERE YOU BUY, OWNING A HOME CAN ALSO BE YOUR BEST INVESTMENT. Generally, you need to live in the home at least four years to recover the extra money paid for closing costs, loan fees, insurance, taxes, and other costs absent with renting. For shorter periods, you may get stung if forced to move when housing prices in the area have dropped due to lack of jobs or overbuilding.

A good investment for many has been home ownership

REAL ESTATE RISKS

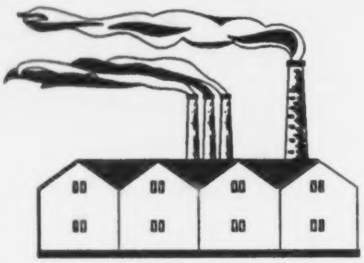
All real estate investments, including private residences, are subject to risks in three major areas: **1) MARKET, 2) POLITICAL, AND 3) INTEREST RATES.** An explanation of each follows.

1. MARKET: **THE MARKET RISK, BASED ON DEMAND, CAUSES PRICES TO GO UP OR DOWN.** New construction in the area is a good sign because it reflects growth, high demand, and accompanying rising home prices. A constant danger in a growing area, however, is overbuilding. With too many available homes and not enough buyers, prices drop.

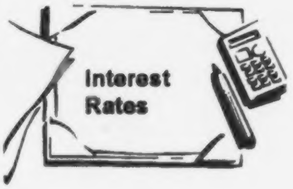


If the area has experienced above average price increases several years prior to your arrival, be cautious. It is difficult to know when prices have reached their peak, or if the appreciation will continue. This is a guess, even for the experts. If possible, you want to avoid paying top dollar for a home if future appreciation is tenuous. The shorter your intended stay in the home, the more careful you need to be in your decision to buy, and the more careful you need to be in your home selection.

The shorter your intended stay in the home, the more cautious you need to be with your buying decision



2. POLITICAL: POLITICAL DECISIONS CREATE JOBS AS WELL AS LAYOFFS. ONE POLITICAL RISK IN HOME BUYING HINGES ON AVAILABLE JOBS IN THE AREA. If a major local employer has massive layoffs from losing a large contract, or other reasons, people will need to move to seek new employment. The large number of vacant homes without buyers creates an oversupply so, accordingly, home prices drop. Another political risk is deductibility of home mortgage interest because it can be changed by political decisions.



3. INTEREST RATES: INTEREST RATES ALSO AFFECT HOUSING PRICES. LOWER INTEREST RATES REDUCE MORTGAGE PAYMENTS, MAKING MORTGAGES AFFORDABLE FOR MORE PEOPLE (see Table 10.2). Due to the lower rates, more buyers can qualify for a home. High interest rates have the reverse effect.

WHAT CAN YOU AFFORD?

Most lenders use a 28/36 ratio to test for mortgage qualifications with a 20% down payment. YOUR MORTGAGE PAYMENT, HOMEOWNER'S INSURANCE, AND PROPERTY TAXES SHOULD NOT EXCEED 28% OF YOUR GROSS INCOME. THE TOTAL OF ALL YOUR LOAN PAYMENTS, INCLUDING THE MORTGAGE, SHOULD NOT EXCEED 36% OF YOUR GROSS INCOME.

Table 10.1 FORMULA FOR MORTGAGE AFFORDABILITY

Mortgage Affordability		
1	Gross Monthly Income =	$
2	Affordable Monthly Payment = *Line 1 x .28*	$
3	Total of all monthly debt = *Line 1 x .36*	$

Example:

You and your spouse have a combined gross monthly income of $4,167. You would qualify for a total monthly mortgage payment of $1,167 per month ($4,167 x .28 = $1,167). The total payment includes mortgage payment, property taxes, and homeowner's insurance.

You could spend up to 36%, or $1,500 per month ($4,167 x .36 = $1,500), for your mortgage payment, property taxes, homeowner's insurance, and other loan obligations having payments beyond one year.

THE 28/36 RATIO IS NOT WRITTEN IN STONE. If you are willing to take an adjustable rate mortgage (ARM), if you have excellent credit, or if you can make a larger down payment, most lenders will raise the ratios slightly. Likewise, if you pay less than 20%, the mortgage lender will lower the ratios.

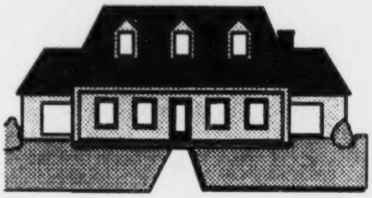
BEFORE PURCHASING A HOME. . .

Before purchasing a home, consider these factors:

- ✓ Are home prices in the general area rising, falling, or are they relatively stable?
- ✓ Are interest rates high or low?
- ✓ Do you expect to live in the home at least four years? For shorter periods, you may not recover your costs unless prices increase significantly during your ownership.
- ✓ If your purchase is for less than four years, what would you pay for a comparable rental? Compare the total costs of home ownership, including mortgage payment, closing costs, taxes, insurance, and upkeep for your intended stay to what rent you would pay for this same period.
- ✓ If renting is less costly, what could you earn by investing the "extra" money you will save by renting?
- ✓ What are the tax benefits of home ownership for your situation? Do you have gains to defer from a prior home sale? Do you need a mortgage interest tax deduction? (Remember, mortgage interest is tax deductible, and no similar deduction exists for rental payments.)
- ✓ Do you have a growing family and need more living space? Can you rent a suitable home for a good price? A yard might be a necessary housing amenity. Homes often have yards, most apartments do not.

MOVING FORWARD WITH THE DECISION TO BUY

Once you make the decision to buy, move forward following these guidelines:



- **PRIORITIZE THE FEATURES YOU WANT IN YOUR NEW HOME.** You may have to compromise, so know what is most important to you.

  ✓ **BEDROOMS** — how many? how large?

  ✓ **YARD** — how large? Maintenance is expensive and time consuming, but also rewarding for those who like it.

  ✓ **KITCHEN AREA** — check out adequate cupboard space and consider how much time you will spend in the kitchen.

  ✓ **LIVING and DINING ROOM** areas.

  ✓ **LAUNDRY** facilities.

  ✓ **GARAGE** and **STORAGE** space.

  ✓ How close are the **NEIGHBORS?**

  ✓ Is the area tranquil or bustling with traffic? Is there distracting street or freeway **NOISE**?

- **FIND A GOOD REAL ESTATE AGENT TO SHOW YOU AROUND THE AREA.** You will not pay extra for this service — the seller pays. Agents know what is on the market in your price range. Have an agent give you a tour of an area that interests you. Look at the location of schools, recreational facilities, shopping, and public transportation.

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- **LOOK AT HOMES IN THE NEIGHBORHOODS WHERE YOU WOULD LIKE TO LIVE.** Real estate agents work on Saturdays and Sundays so use this time to review what is on the market.

- **KNOW WHAT YOU CAN AFFORD FOR A MORTGAGE** (See Table 10.2). Take your most recent pay stub and tax return to a prequalifying interview with a loan officer from a reputable mortgage lender in the area.

- **LEARN THE TRAFFIC PATTERNS AND COMMUTE TIME FROM THE POSSIBLE HOME SITES.** Visit the neighborhood during a weekday to get a realistic idea of peak driving times and traffic noise. Visit the neighborhood again on the weekend to get a feel for the activity level of the area.

- **MAKE AN OFFER BASED ON SIMILAR PROPERTIES WITH RECENT SALES** (past three months).

- **BEFORE YOU SIGN THE FINAL PAPERS, INSIST ON A THOROUGH HOME INSPECTION.** It is a good idea to hire an independent inspector to look at the structure and appliances for you. The inspection may cost you several hundred dollars, but will reveal potential flaws in the property, e.g. termites, unusable soil, poor drainage, needed roof repairs, and potential electrical or plumbing problems. The inspection could uncover problems you never considered. Furthermore, if you do find problems that are expensive to fix, you can renegotiate a better deal with the seller.

SURVIVING AN ESCROW CLOSING

IF YOU CAN FIND A KNOWLEDGEABLE LOAN OFFICER WHO WILL LEAD YOU THROUGH THE LOAN PROCESS, THIS PERSON IS WORTH THEIR WEIGHT IN GOLD. An inexperienced or incompetent loan officer will test your patience, if not drive you crazy, and could cost you needless extra money.

APPLICATION

The loan officer takes your application and prequalifies you for the loan. The loan officer obtains the required information for the loan package, then usually gets approval from a second source: an office manager, supervisor, or another department. Generally, the completed loan package consists of:

- ✓ Your completed, signed application
- ✓ A recent credit report
- ✓ A recent appraisal on the property you wish to purchase
- ✓ Verification of your employment
- ✓ Your most recent tax return, or if you are self-employed, a profit and loss statement and your three most recent tax returns
- ✓ Verification of your savings and checking account balances
- ✓ Verification of the balances owed on your monthly debts

YOU WILL BE ASKED TO MAKE A 'GOOD FAITH' DEPOSIT UP FRONT BETWEEN $400 - $500. NORMALLY, IT IS NON-REFUNDABLE. It covers the up front costs of securing a credit report and an appraisal.

In completing the required information for the loan package, don't be overly surprised if skeletons you have forgotten come out of the closet. You may be asked to explain why you were late making a $25 credit card payment several years ago, or you may discover that one of the institutions you borrowed from gave incorrect information, so you now have to prove that you really did pay off their loan. You may have to explain a late car payment when you were on vacation or out of the country. Written explanations to most of the questions raised through a credit check are usually sufficient to satisfy most lenders.

Interest rate on your loan Is Important

AS YOU APPROACH THE CLOSING DEADLINE, YOUR LOAN OFFICER MAY ASK YOU IF YOU WANT TO LOCK IN THE CURRENT INTEREST RATE. Once you lock in a rate, that is the rate you will receive on the loan even if general rates go up or down. If the officer doesn't provide you with interest rate information, ask for the interest rate guidelines. This is especially important if current rates are low and expected to rise.

Your loan officer will work for a lending institution like a **BANK, CREDIT UNION,** or **MORTGAGE COMPANY.** A bank or credit union loans you the money directly. Many mortgage companies find an investor interested in buying your mortgage and sell it to them.

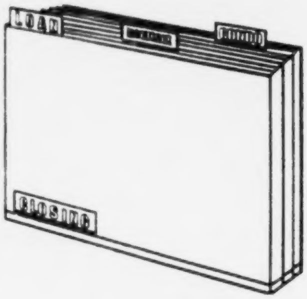
BUYING A HOME IS A LEGAL PROCEDURE INVOLVING NUMEROUS DETAILS. TYPICALLY, AN ESCROW COMPANY WILL DRAW UP THE FINAL SETTLEMENT STATEMENT. It gives a breakdown of all your closing costs, payment made toward them, and the balance due. It also shows the contract price for the property. **THE ESCROW COMPANY TAKES CARE OF LEGALITIES SUCH AS:**

- ✓ **TITLE SEARCH.** Making certain the property you are about to buy is legally registered to the seller and has no unusual liens or judgments against it other than the mortgage(s) revealed by the seller.
- ✓ Preparing the **TRUST DEED** in your name and recording it with the County Recorder in the county where the property is located.
- ✓ **PRORATING** taxes, insurance, interest, and other assessments **BETWEEN YOU AND THE SELLER** on the final settlement statement. For example, if you are scheduled to take title on October 1, you will be charged with three months of property taxes and insurance. The seller will be responsible for paying these same charges for the first nine months of the year. If you do not close on the first of the month, you will be charged with a portion of the month's interest.
- ✓ **PAY TAXES, INTEREST, AND OTHER ASSESSMENTS** due to the appropriate parties.
- ✓ **COLLECT MONIES** due from both parties, pay the seller, and pay off all existing mortgages or liens on the property.

Closing Costs and Final Settlement Statement

YOU WILL RECEIVE A SETTLEMENT STATEMENT THAT SHOWS ALL AMOUNTS PAID BY YOU AND BY THE SELLER. If you will own the home as of October 1, you will pay for the annual city and county taxes for your three months of ownership. These may be collected as part of the closing costs. Mortgage interest (if you do not close on the first day of the month) and homeowner's insurance will also be prorated and paid in advance on this settlement statement.

OTHER CLOSING COSTS NORMALLY PAID BY THE BORROWER INCLUDE A LOAN ORIGINATION FEE OR LOAN DISCOUNT FEE, OFTEN REFERRED TO AS 'POINTS.' The loan origination fee is a commission paid to the mortgage company or lending institution for preparing the loan package. A loan discount is an amount you pay up front to get a lower interest rate. It is the same as prepaid interest. **YOU CAN DEDUCT THESE POINTS ON YOUR INCOME TAXES IN THE YEAR PAID IF THE TOTAL AMOUNT YOU PAY OUT OF POCKET FOR CLOSING COSTS EQUALS OR EXCEEDS THE POINTS PAID.** You can also deduct property taxes paid in escrow.



You will pay for **TITLE INSURANCE.** It is required by lenders to protect their investment in the property. Through this insurance, lenders have a guaranteed dollar amount in the property if ownership is somehow contested through the courts and they should lose title. While title insurance and other costs, plus recording and transfer fees, are not tax deductible, you can add them to the price paid for the home to reduce your gain upon selling. All of these costs are called **CLOSING COSTS.**

Private Mortgage Insurance (PMI)

PRIVATE MORTGAGE INSURANCE IS AVAILABLE THROUGH MOST LENDERS. BY TAKING OUT A POLICY TO PROTECT THE LENDER, YOU CAN MAKE A SMALLER DOWN PAYMENT SUCH AS 5% OR 10%. The insurance protects the lender from declining prices when they have invested more than 80% of the market value in the property. Lenders have a guaranteed dollar amount in the property through the insurance even if real estate prices drop. **PRIVATE MORTGAGE INSURANCE IS NEARLY ALWAYS REQUIRED WHEN EQUITY IN THE PROPERTY IS LESS THAN 20%.**

Buying private mortgage insurance might allow you to put less money down

IF YOU MUST OBTAIN PMI, YOU CAN CANCEL IT AFTER TWO YEARS IF EQUITY IN THE HOME GROWS BEYOND 20%. Your equity increases through general rising home prices, through improvements to the property, and/or a reduction of the principal balance on the loan. You (the borrower) need to petition

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the lender to cancel the PMI insurance. LENDERS ARE NOT REQUIRED TO NOTIFY BORROWERS WHEN THEY NO LONGER REQUIRE THIS INSURANCE.

YOUR MORTGAGE

Several types of mortgages are available. YOU CAN GET A MORTGAGE FOR 15 YEARS OR FOR 30 YEARS. YOU CAN GET A FIXED INTEREST MORTGAGE OR AN ADJUSTABLE RATE MORTGAGE, COMMONLY REFERRED TO AS AN ARM. TO DETERMINE THE BEST TYPE OF MORTGAGE FOR YOUR SITUATION, LOOK AT YOUR TAXABLE INCOME, HOW MUCH YOU CAN AFFORD, AND HOW LONG YOU EXPECT TO LIVE IN THE HOUSE.

Rising and falling interest rates change the size of a mortgage payment, thus influencing the amount you can afford. The following table gives the monthly payment due on principal and interest for different mortgages with various interest rates.

Table 10.2 MONTHLY MORTGAGE PAYMENTS FOR VARIOUS INTEREST RATES

The monthly mortgage payments for various interest rates are in the boxes to the right of the mortgage amount. $5,000 and $10,000 amounts are given in the table so you can easily add or multiply to get a variety of possible sums.

Example:

If you are looking at a $130,000 mortgage, take the $10,000 amount, multiply it by 3 ($10,000 x 3 = $30,000), and add it to the $100,000 amount.

Mortgage Amount	Interest Rate													
	7%		7.5%		8%		8.5%		9%		9.5%		10%	
	15 Yr	30 Yr	15 Yr	30 Yr	15 Yr	30 Yr	15 Yr	30 Yr	15 Yr	30 Yr	15 Yr	30 Yr	15 Yr	30 Yr
$5,000	**45**	33	**46**	35	**48**	37	**49**	38	**51**	40	**52**	42	**54**	44
$10,000	**90**	67	**93**	70	**96**	73	**98**	77	**101**	80	**104**	84	**107**	88
$50,000	**449**	333	**464**	350	**478**	367	**492**	384	**508**	403	**522**	420	**538**	439
$75,000	**674**	499	**695**	524	**717**	550	**739**	577	**761**	603	**783**	631	**806**	658
$100,000	**899**	665	**927**	699	**956**	734	**985**	769	**1,015**	805	**1,044**	841	**1,075**	878

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Adjustable Rate Mortgages

ADJUSTABLE RATE MORTGAGES HAVE CHANGING INTEREST RATES. Most cannot increase more than 2% in any year or more than 6% over the lifetime of the mortgage, but do not assume these ceilings are part of your mortgage. Find out the parameters of the mortgage from the lender. **LAW REQUIRES LENDERS TO GIVE FULL DISCLOSURE ON ALL FEATURES OF THE ARM. MOST ARM'S MOVE WITH:**

- The 3 month or 6 month **TREASURY BILL RATE**
- The Federal Home Loan Bank Board's **'COST OF FUNDS' RATE**
- The yield on **TREASURY SECURITIES** maturing in one, three, or five years
- The '**NATIONAL AVERAGE MORTGAGE RATE.**' This is an average of loan rates during a specified period

EACH LENDER WILL MARK UP THE COST OF THE LOAN TO INCLUDE THEIR PROFIT. These markups vary, so ARM's based on the same index will also vary according to the lender's profit margin. **THIS MAKES LOAN SHOPPING IMPORTANT.**

ARM'S ARE A GOOD LOAN CHOICE FOR THOSE BUYERS WHO EXPECT TO HAVE THE MORTGAGE FOR ONLY A FEW YEARS. But, before signing any documents, make sure you know:

- **WHICH INDEX THE ARM IS TIED TO,** such as the Cost of Funds Index or the Treasury Securities Index. Have the lender show you a history of how these rates have changed over the past several years.
- **THE PROFIT MARGIN FOR THE LENDER** that is added to the index to set the actual rate of the mortgage.
- **HOW OFTEN THE RATE CHANGES, AND THE LIMITS ON THESE CHANGES IN ANY GIVEN YEAR AND OVER THE LIFE OF THE LOAN.** Don't assume your cap will be 2% each year and 6% over the life of the mortgage.
- **IS THE ARM CONVERTIBLE TO A FIXED RATE MORTGAGE,** and if it is convertible, how often, and at what cost?

Fixed Interest Rate Mortgages

15 and 30 Year

Looking at the mortgage interest payments in Table 10.2 shows that the 30 year mortgage has lower payments than the 15 year mortgage. **THE 30 YEAR MORTGAGE HAS LOWER PAYMENTS BECAUSE YOU HAVE DOUBLED THE TIME TO RETIRE THE PRINCIPAL.** Some people like the idea of a 15 year mortgage because they will pay considerably less interest over the life of the loan and have their house paid off in 15 years instead of 30.

TO TAKE ADVANTAGE OF THE BENEFITS OF A 15 YEAR MORTGAGE AND MAINTAIN MORE FLEXIBILITY, TAKE THE 30 YEAR LOAN, THEN MAKE DOUBLE PRINCIPLE PAYMENTS TO REDUCE THE BALANCE. This plan will pay off the loan in 15 years, but doesn't tie you in to the higher monthly payments required under the 15 year schedule. Should you experience unexpected cash flow problems, you can miss several of the "double principal" payments and make them up later when you have the money.

CO$T

Prepaying Mortgages

By prepaying next month's principal with your current mortgage payment, you save that entire month's interest expense. An amortization schedule for your loan is necessary to determine the breakdown between principal and interest so you can add next month's principal to this month's payment. Table 10.3 shows an amortization schedule for one year for a $95,000, 30 year mortgage at 8% interest. The monthly payment is $697.08. Over the life of this 30 year loan, $155,949 would be paid in interest. By prepaying next month's principal with this month's payment, you can pay off the loan in 15 years. The additional principal payments over this 15 year period total $22,058, an average of $1,471 per year. But, making these additional payments will save a whopping $103,417 in interest! The total interest paid over the 15 years by making double principal payments is $52,532 compared to $155,949 under the 30 year loan. Also, as you pay more principal, you increase your equity in the home.

idea

Take the 30 year loan and make double principal payments to reduce your balance

Prepaying next month's principal with this month's payment saves an entire month's interest expense

Look at the amortization schedule in Table 10.3. Add the principal from Payment #2 to Payment #1. Add the principal from Payment #3 to Payment #2, etc. Each time you make an additional principal payment, cross it off your list. Continue adding next month's principal to this month's regular monthly payment.

As you pay more principal, you increase your equity

Example:

Payment 1 Add $64.17 to scheduled payment of 697.08
Payment 2 Add $64.60 to scheduled payment of 697.08
Payment 3 Add $65.03 to scheduled payment of 697.08

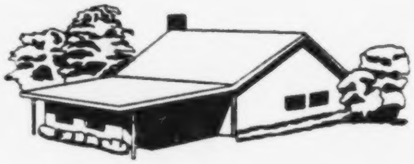

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Table 10.3 LOAN AMORTIZATION

$95,000 Loan @ 8% for 30 Years
Payment: 697.08 Per Month

Payment #	Principal	Interest	Balance
			95,000.00
1	63.75	633.33	94,936.26
2	64.17	632.91	94,872.09
3	64.60	632.48	94,807.49
4	65.03	632.05	94,742.47
5	65.46	631.62	94,677.01
6	65.90	631.18	94,611.11
7	66.34	630.74	94,544.78
8	66.78	630.30	94,478.01
9	67.22	629.85	94,410.77
10	67.67	629.41	94,343.00
11	68.12	628.95	94,274.98
12	68.58	628.50	94,206.40

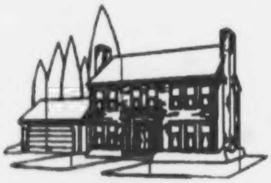
Additional Principal Paid

Year 1	793.61	Year 9	1,501.85	
Year 2	859.46	Year 10	1,626.49	
Year 3	930.79	Year 11	1,761.52	**Total Paid**
Year 4	1,008.05	Year 12	1,907.71	**$22,057.58**
Year 5	1,091.71	Year 13	2,066.04	
Year 6	1,182.35	Year 14	2,237.52	
Year 7	1,280.48	Year 15	2,423.23	
Year 8	1,386.77			

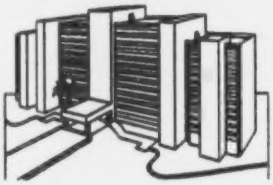
People use various methods for prepaying mortgages. Some send the lender an additional 10%. Some lenders even have a plan of paying mortgages using biweekly instead of monthly payments. Paying biweekly can pay off the mortgage nearly 10 years sooner. Before starting a prepayment plan, it is a good idea to notify your lender of your intentions. Then make a notation on each payment voucher of the extra money you have sent in. You can also pay the additional amount with a second check to make record keeping clear if discrepancies arise.

SECOND HOMES

CURRENTLY, CONGRESS ALLOWS TAXPAYERS TO DEDUCT HOME MORTGAGE INTEREST ON TWO HOMES AS LONG AS THE TOTAL OWED ON BOTH HOMES DOES NOT EXCEED ONE MILLION DOLLARS (Is this because most politicians have two homes?). These second homes can be:



- **VACATION HOMES** which the owner rents and also uses personally. The rental income is tax free if rented for 14 days or less.



- **TIMESHARES,** if they are deeded timeshares where the taxpayer owns the property, and if the owner uses it less than 15 days per year.
- **BOATS** and **MOBILE HOMES** that have basic living facilities.

Any second home that you rent is also referred to as a vacation home. **IF YOU OWN A SECOND HOME, A BOAT, MOBILE HOME, OR TIMESHARE THAT QUALIFIES AS A SECOND HOME, YOU CAN TAKE ADVANTAGE OF A TAX LAW THAT PERMITS YOU TO RENT IT UP TO 14 DAYS WITHOUT CLAIMING THE INCOME FROM THE RENTAL.** If you rent beyond the 14 days, the rules change and you must claim the income, but can also take offsetting expenses up to the amount of income earned.

REFINANCING AND HOME EQUITY LOANS

REFINANCING OCCURS WHEN YOU REPLACE YOUR CURRENT LOAN WITH A NEW LOAN. Consider refinancing when current mortgage rates are 2% or more below your existing mortgage rate. **BEFORE REDOING YOUR LOAN, FIND OUT HOW MUCH YOU WILL PAY FOR CLOSING COSTS, POINTS, AND OTHER FEES, AND HOW MUCH YOU WILL SAVE WITH YOUR NEW MORTGAGE PAYMENT OVER THE OLD.**

Then, look at how many months it will take you to recover the costs of refinancing. If you plan to stay in the house beyond this "recovery" period, refinancing is worthwhile.

UNLESS ALL OF THE LOAN PROCEEDS ARE USED FOR HOME IMPROVEMENTS, POINTS PAID FOR REFINANCING ARE NOT FULLY TAX DEDUCTIBLE, EVEN IF PAID OUT-OF-POCKET. They must be amortized over the life of the loan. This means if you pay $2,000 in points for a new 30 year loan, you can only deduct $67 each year ($2,000 ÷ 30 = $67). If you pay off this refinanced loan, you can deduct the points not taken in the year the loan is paid off.

A home equity loan is secured by a second deed of trust on the property

HOME EQUITY LOANS ARE AVAILABLE FOR THOSE WHO HAVE MORE THAN 20% EQUITY IN THEIR HOME. The lending institution will carry a second trust deed on the property for the amount of the home equity loan they give you. For example, if the market value of your home is $150,000 and you have a first mortgage of $90,000, and you have a good credit rating, you would qualify for a home equity loan of approximately $30,000 ($150,000 x 80% = $120,000). Some lenders give loans up to 10% of equity, but charge higher interest and/or fees. **MOST LENDERS WILL LOAN UP TO 80% OF THE MARKET VALUE OF THE HOME.**

A HOME EQUITY LINE OF CREDIT GIVES YOU A LINE OF CREDIT UP TO YOUR QUALIFYING AMOUNT, ALSO SECURED BY A SECOND TRUST DEED. The lending institution will give you checks that you can use against the credit balance. It works like revolving credit. You can "charge" up to your limit, then when you pay off or pay down the balance, you can reuse the available credit line for another purpose.

The advantage of a home equity loan or home equity line of credit is that the interest rate is much lower than credit card rates. The money can be used for any purpose, and within limits, the interest is fully deductible as "mortgage interest" on your personal income tax. **CURRENT TAX LAW LIMITS DEDUCTIBLE HOME EQUITY DEBT SECURED BY SECOND TRUST DEEDS TO $100,000 FOR COUPLES, AND $50,000 FOR SINGLES. THESE AMOUNTS ARE TOTALS ALLOWED ON ALL HOME EQUITY DEBT FOR FIRST AND SECOND HOMES.**

TAX BENEFITS OF HOME OWNERSHIP

MORTGAGE INTEREST AND PROPERTY TAXES PAID ON A HOME ARE NORMALLY THE DEDUCTIONS THAT ALLOW A TAXPAYER TO TAKE ITEMIZED DEDUCTIONS. Tax law allows a taxpayer to take either a standard deduction or itemized deductions, whichever is greater. With itemized deductions, in addition to writing off mortgage interest and property taxes, a taxpayer can also deduct state and local taxes paid, charitable contributions, and varying percentages of employee business expenses, investment expenses, casualty and theft losses, and medical expenses. Without the mortgage interest deduction, most taxpayers do not have enough applicable expenses to itemize, so they lose the write-offs.

Because mortgage interest is tax deductible, it saves money that would otherwise be paid in taxes. Use your tax bracket (see the Appendix: *Tax Bracket*) to determine your net cost for a mortgage.

For example:

If your mortgage interest is $900 a month, or $10,800 a year, and your tax bracket is 35% (28% federal + 7% state), you will have a $3,780 tax reduction due to the mortgage interest you paid ($10,800 x 35% = $3,780). Considering you save $3,780 in taxes, your net cost of the mortgage is $7,020. Table 10.4 shows the net after-tax cost of a home mortgage for various tax brackets and interest rates.

Table 10.4 NET COST OF A MORTGAGE

Tax Bracket	Interest Rate On Mortgage			
	7%	8%	9%	10%
	NET OR REAL COST OF MORTGAGE			
22% (15% + 7%)	5.46%	6.24%	7.02%	7.8%
35% (28% + 7%)	4.55%	5.20%	5.85%	6.5%
38% (31% + 7%)	4.34%	4.96%	5.58%	6.2%
43% (36% + 7%)	3.99%	4.56%	5.13%	5.7%
46.6%(39.6%+7%)	3.74%	4.27%	4.8%	5.34%

TAX CONSEQUENCES OF SELLING YOUR HOME

IF YOU SELL YOUR HOME AND MAKE A PROFIT, TAX LAW REQUIRES YOU TO REPORT THE GAIN. THE LAW DOES NOT ALLOW YOU TO DEDUCT A LOSS FROM THE SALE OF A PERSONAL RESIDENCE. YOU CAN, HOWEVER, POSTPONE ALL OR A PORTION OF YOUR GAIN BY PURCHASING ANOTHER HOME WITHIN TWENTY-FOUR MONTHS IF THE PRICE OF THAT HOME IS EQUAL OR GREATER THAN YOUR PROFIT ON THE SALE.

Your profit is the same as your gain. The IRS refers to this profit as the amount realized. YOUR PROFIT IS THE NET SALES PRICE (THE CONTRACT SALES PRICE MINUS SELLING COSTS SUCH AS REAL ESTATE COMMISSIONS AND CLOSING COSTS) MINUS THE HOME'S BASIS (THE PRICE PAID, PLUS PURCHASING COSTS, PLUS IMPROVEMENTS AND MINUS ANY PRIOR GAINS).

Net sales price minus home's basis equals your profit (gain)

Sales Price
Minus
Selling Costs
Minus
Fixing-Up Expenses
Equals
Net Sales Price

Price Paid
Plus
Purchasing Costs
Plus
Improvements
Minus
Prior Deferred Gains
Equals
Home's Basis

FIXING-UP EXPENSES INCLUDE WORK DONE ON THE HOME TO MAKE IT MORE SALABLE. These expenses also reduce the net sales price if done within 90 days prior to signing the sales contract.

While improvements add to a home's basis, repairs do not. Improvements add to the value of the structure; repairs only maintain its value. Building a deck or putting on a new roof are improvements, but restoring a deck or fixing a leaking roof are repairs. You can only use improvements to increase a home's cost basis. **(SEE 'HOME IMPROVEMENTS GENERALLY INCLUDED IN BASIS' AT THE END OF THIS CHAPTER.)**

Improvements
add to a home's basis.
Repairs
do not

DEFERRING A GAIN IS MANDATORY IF A NEW HOME IS BUILT OR PURCHASED WITHIN TWO YEARS AFTER THE PREVIOUS HOME SELLS. This means if you make a profit, you do not pay tax on the money made. The profit is carried over to the second home to reduce the second home's basis. Unless you must move due to job relocation, you currently cannot defer the gain if you sell more than one house during any two year period.

IF YOU DECIDE NOT TO PURCHASE A REPLACEMENT HOME, YOU WILL PAY TAXES ON THE PROFIT. Furthermore, you cannot add the gain to a later year's income. You must amend your tax return for the year of sale, and add the gain to that year's income.

You can continue to postpone gains from succeeding home sales as long as the new homes purchased have equal or greater value than the net sales price from the prior sale. **IF THE PRICE OF A REPLACEMENT HOME IS LESS THAN THE NET SALES PRICE, YOU WILL PAY TAXES ON THE DIFFERENCE.** For example, if your gain from Home #1 is $95,000 and Home #2 costs $85,000, you will pay taxes on the $10,000 difference.

To defer all of your gain,
the new home purchased
must be of equal or greater value
than your net sales price

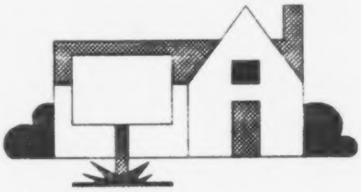
At age 55 or older, a homeowner can exclude up to $125,000 of postponed gains from the sale of a personal residence

A homeowner can exclude up to $125,000 of "postponed" gains at age 55 or older. This means $125,000 of tax free gains are offered only once to any one person or couple. To qualify for this exclusion, the homeowners must live in the home for three out of the five years preceding the sale. Once a couple takes this exclusion, neither of them may take it again. If either of them remarry, due to divorce or death, because they took the exclusion earlier their new spouse *cannot*. This is true even if the new spouse has a separate home and has never taken the exclusion.

To illustrate the consequences of buying and selling several homes, let's follow what happened to Mr. and Mrs. Embry through the sale of three personal residences.

Home #1

The Embrys bought their first home for $15,000 in California during the early sixties. Closing costs were $300. They built a patio and deck for $3,000, then spent $2,500 for landscaping and a sprinkler system. Later, they added sidewalks and a fence for another $2,500. Total improvements equaled $8,000 ($3,000 + $2,500 + $2,500 = $8,000.) Their basis is $23,300; $15,000 original cost, plus $300 closing costs, plus $8,000 for improvements. Twenty years later they sold this home for $95,000. The sales commission was $5,700. Other closing costs were $1,400, making total expenses of the sale $7,100 ($5,700 + $1,400 = $7,100).



Sales Price	$ 95,000
Expenses of Sale	7,100
Net Sales Price	**$ 87,900**

Net Sales Price	$ 87,900
Minus Basis	– 23,300
Gain	**$ 64,600**

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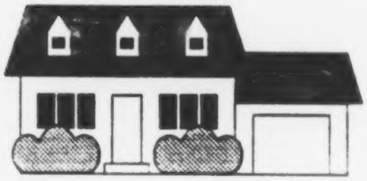
Home #2

The Embrys postponed their taxable gain of $64,600 because they purchased a second home within the two year period and the price they paid for Home #2 exceeded $87,900, their net sales price. They purchased their second home for $110,000 and had closing costs of $1,400. During their stay in Home #2, their improvements totaled $35,000: $15,000 for a room addition, and $20,000 for a patio, deck, and swimming pool. After living in Home #2 for five years, they sold it for $190,000. They paid a 6% sales commission of $11,400, plus closing costs of $1,700, for $13,100 in total sales expenses.



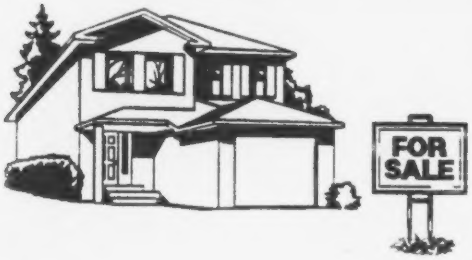
Basis For Home #2	
Purchase Price + Closing Costs	$ 111,400
Minus Prior Gain	- 64,600
Plus Improvements	+ 35,000
Basis	**$ 81,800**

Sales Price	$ 190,000
Expenses of Sale	- 13,100
Net Sales Price	**$ 176,900**

Net Sales Price	$ 176,900
Minus Basis	- 81,800
Gain	**$ 95,100**

Home #3

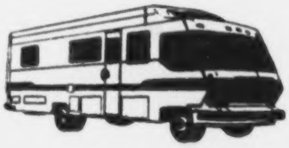
Mr. and Mrs. Embry relocated to another state and purchased a third home within the twenty-four month period. The third home cost $205,000 and had closing costs of $2,300. They lived in this home for seven years until Mr. Embry was 55 years old, then sold again. Again, notice how the deferred gain of $95,100 on Home #2 reduces the basis of Home #3. They made no improvements to their third home, which sold for $230,000. The expenses of sale were $15,000, including sales commissions and closing costs.



Basis For Home #3	
Purchase Price + Closing Costs	$ 207,300
Minus Prior Deferred Gain	- 95,100
New Basis on Home #3	**$ 112,200**

Sales Price	$ 230,000
Expenses of Sale	- 15,000
Net Sales Price	**$ 215,000**

Net Sales Price	$ 215,000
Minus Basis	$ 112,200
Gain	**$ 102,800**



Since Mr. Embry is over 55 years old, they were able to take advantage of the once in a lifetime exclusion, which allows them to take up to $125,000 in tax free gains from the sale of a personal residence. As required, they had lived in the home for three out of the five years prior to the sale. **THE ONCE IN A LIFETIME EXCLUSION ALLOWED THE EMBRY'S TO RECEIVE $102,800 TAX FREE.** They made a down payment on a smaller home, and with the balance of the money, bought a motorhome to travel around the country.

The money earned from a home sale does not need to be reinvested in the replacement home to defer the gain

The Embrys never paid taxes on the profits from any of the homes they sold because each time they purchased a new home that cost more than their net sales price. **TO DEFER ALL TAXES ON A HOME SALE, YOU MUST BUY A REPLACEMENT HOME THAT EXCEEDS YOUR NET SALES PRICE.**

THE MONEY EARNED FROM A HOME SALE DOES NOT NEED TO BE REINVESTED INTO THE REPLACEMENT HOME. The requirement is to buy a new home that costs more than the net sales price. For example, if you have an $80,000 gain on the sale of a personal residence and you buy a replacement home for $85,000, you will owe no tax on your profits. This is true even if you come out of escrow with $30,000 and use your "home sale profit" to purchase a mutual fund, or to take a yearlong leave of absence.

SOMETIMES, A NEW HOME IS PURCHASED FOR LESS THAN THE GAIN ON THE OLD HOME. IN THIS CASE, CAPITAL IMPROVEMENTS MADE TO THE NEW HOME CAN BE USED TO INCREASE YOUR NEW HOME'S BASIS (PURCHASE PRICE + IMPROVEMENTS) IF THESE IMPROVEMENTS ARE COMPLETED WITHIN TWO YEARS FROM THE DATE THE FORMER HOME SELLS.

The IRS is very strict about the 24 month rule

WHEN POSTPONING A GAIN FROM THE SALE OF A HOME, THE IRS IS VERY STRICT ABOUT THE TWENTY-FOUR MONTH RULE. You must be living in your "new home" at the end of the 24 month period. When building, if construction is delayed due to no fault of yours and you can't move in on time, you can-

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not defer the gain. You would have to amend your tax return for the year of the sale, and add the gain to that year's income. The IRS will also charge you two years of interest on the taxes due on the amended return.

When building, it is a good idea to have a clause in your contract requiring the builder to pay you a certain amount of money if your finish date is delayed beyond the required 24 months. Such a clause will compensate you for the extra taxes you will owe if construction is not completed by the required move-in date.

REAL ESTATE, LEVERAGE, AND OPM

LEVERAGE IS USING BORROWED MONEY TO MAKE MONEY. IT IS ALSO REFERRED TO AS OPM, OR 'OTHER PEOPLE'S MONEY.' The rate of return on the amount of money you make is based on the amount of money invested. With leverage, you can take advantage of the appreciation on the total value of a property, although you put down only 5% - 20% of its market value.

MAJOR VALUES

If you select real estate in the right location, leverage can make you money. Historically, real estate has been a good inflation hedge. The value increases each year to keep up with, or ahead of, overall rising prices. To make money in real estate, location is everything. The higher the demand, the greater the increase in value. If the property isn't in demand, the price won't go up

WHEN YOU PURCHASE REAL ESTATE WITH A DOWN PAYMENT AND A MORTGAGE, YOU USE LEVERAGE (OR OPM) TO MAKE YOUR PROFITS. AS THE PROPERTY OWNER, YOU RECEIVE ALL OF THE BENEFITS OF OWNERSHIP, WHETHER THEY ARE TAX BENEFITS OR AN INCREASE IN EQUITY THROUGH APPRECIATION ON THE PROPERTY. The bank or lender does not share in these benefits with you. With leverage and a good loan, you stand to earn more than if you owned the property outright.

Assume you purchase several acres in an area where you expect to see future growth. You pay $50,000 for the land. Over the next two years, the property increases in value to $75,000. The property taxes are $500 per year. To see the power of using leverage and OPM, let's compare the difference in profits if you had paid $50,000 cash for the land as opposed to the down payment and the mortgage approach. **TO CALCULATE YOUR RATE OF RETURN, LOOK AT THE MONEY YOU MAKE WITH THE MONEY YOU SPEND.**

Example:

In the **leverage** example, you purchase the land with a 20% down payment of $10,000 and a mortgage for $40,000 at 8% for 15 years. The payment on the mortgage is $384 per month and the property tax is $500 a year. At the end of the two year period, you have made $9,216 in payments.

In the **cash or outright** purchase example, you pay $50,000 cash for the same piece of land. Taxes remain the same, at $500 per year.

Money Spent

Leverage		Cash	
Down Payment	$10,000	Purchase Price	$50,000
Money invested in monthly payments $384 x 24	$ 9,216		
Property Taxes (2 Yrs.)	$ 1,000	Property Taxes (2 Yrs.)	$ 1,000
Total Money Spent	$20,216	Total Money Spent	$51,000

Yield and Profit

Leverage		Cash	
Sales Price	$75,000	Sales Price	$75,000
Balance on Mortgage	$37,002	Balance on Mortgage	0
Profit to owner based on total money spent	$37,998	Profit to owner based on total money spent	$24,000
Profit per year	$18,999	Profit per year	$12,000
Annual rate of return on money spent	94%	Annual rate of return on money spent	23.5%

This simplified example does not include commissions, fees, and other expenses. The profits would be lowered by the cost of these additional expenses, but would be the same in both cases so they would not change the difference that leverage makes in the rate of return. **MANY PEOPLE HAVE MADE MONEY BY TAKING ADVANTAGE OF REAL ESTATE APPRECIATION WITH A MINIMUM PURCHASE IN THE PROPERTY. YOU CAN EVEN USE THE EQUITY BUILDUP TO GET A LOAN TO PURCHASE ADDITIONAL PROPERTIES.**

LIKE ALL INVESTMENTS, REAL ESTATE ALSO HAS ITS RISKS. IF NO BUYER EXISTS FOR THE PROPERTY, YOU ARE STUCK WITH IT. Some real estate is not easy to buy into, while other real estate is not easy to get out of. To make money, the property must be in demand. Demand will make it appreciate in value. A change in zoning laws, a surge in interest rates, or a downturn in the market can all affect what you hope to earn.

Table 10.5 HOME IMPROVEMENTS GENERALLY INCLUDED IN BASIS

- **APPLIANCES, MAJOR HOUSEHOLD:** Clothes dryer, freezer, room air conditioner, stove, washing machine (appliances must be sold with the home).
- **BATHROOMS:** Bathtub sliding doors, faucets, medicine cabinets, mirrors, shower controls, toilets, towel racks.
- **BUILDING IMPROVEMENTS:** New siding, deck, fireplace, mantel, garage, gutters, drainpipes, porch screen and storm doors, tool shed, new roof or extensive improvements, termite inspection, waterproofing, patio.
- **COMMUNICATIONS:** Call bells, chimes, fire or burglar alarms, intercoms, cable TV installation, permanent telephone outlets.
- **ELECTRICITY AND LIGHTING:** Replacement of fuses with circuit breakers, floodlights, lighting fixtures, rooftop TV antenna and wiring.
- **FLOORING:** Wall-to-wall carpeting, tile, linoleum, wood floors.
- **WINDOWS AND DOORS.** Mini-blinds and drapes, screens, storm windows and doors, weather stripping.
- **WALLS AND CEILINGS:** Insulation, wallpapering, wood paneling.
- **RENOVATION:** Conversion of unfinished basement or attic into areas such as recreation rooms or bedrooms.
- **PLUMBING:** Copper tubing, sump pump, water pipes, water supply system, septic system, water purifier, water softener, humidifiers attached to furnace.
- **LAUNDRY:** Laundry tub, laundry chute, ventilator.
- **KITCHEN:** Built-in dishwasher, garbage disposal, range hood, countertops, microwave ovens, trash compactors, extra storage cupboards.
- **FURNITURE AND FIXTURES:** Built-in bookcases, cabinets, closet shelves
- **GARDEN GROUNDS, OUTDOOR:** Barbecue pit, birdbath, decks, patios, terraces, fences, greenhouse, landscaping, mailbox, swimming pool, trees and shrubs, underground sprinkler system.

PART IV

Protection

You may think you have a better use for your money than spending it for insurance. The truth is, you cannot safely build your net worth without protecting your assets. Property is vulnerable to unexpected weather conditions. People are vulnerable to accidents and illness. Although insurance costs money, it is a good friend. If you suffer a large loss, owning the right kind of insurance can save you from financial disaster.

The money you spend to preserve assets such as your earning power, your health, your home, and your possessions is money well spent. Without adequate protection, you stand to lose what you work so hard to get. No man or woman can avoid exposure to the hazards of life as long as he or she works, plays, and breathes. With exposure, potential tragedies do occur. **BE WISE AND PROTECT YOURSELF AGAINST UNEXPECTED LOSSES.**

Health &
Disability

Homeowners

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Chapter 11

Insurance Principles

WHY INSURANCE?

When you own insurance, you have an agreement with the insurance company that the company will compensate you for covered losses. Typical losses include death, disability, illness, and destruction or theft of property. You buy a dollar amount of protection with the premium dollars you spend. Even if you have made only one premium payment, law requires insurance companies to pay the agreed amount.

When you own insurance, the insurance company compensates you for covered losses

BENEFITS

LIFE INSURANCE gives financial protection from the loss of a person's life so dependents do not suffer when the wage earner who supports them dies. Likewise, with "key man" life insurance, businesses do not suffer when a key employee dies. **HEALTH INSURANCE** covers the medical bills for short-term and extended illness of all the persons covered under the plan. **DISABILITY INSURANCE** works to replace a percentage of the insureds salary for the period he or she is unable to work.

PROPERTY AND CASUALTY INSURANCE includes **HOMEOWNER'S, RENTER'S** and **AUTOMOBILE POLICIES.** Homeowner's and renter's insurance covers dwellings and/or personal possessions from such losses as fires, floods, and thefts. These policies also offer liability protection. They protect the insured from lawsuits when a person is injured on the property. Automobile insurance pays for damages to persons and property when automobiles, trucks, boats, trailers, and recreational vehicles are involved in accidents, fires, thefts, and other hazards. Each type of insurance will be discussed separately after some ideas about how insurance started, how it is regulated, and how it is sold.

PART IV. Protection

BACKGROUND

A policyholder files a claim with an insurance company to collect money for the damages from a covered loss

THE IDEA BEHIND INSURANCE IS TO COLLECT A SMALL SUM OF MONEY FROM MANY PEOPLE TO RAISE SUFFICIENT FUNDS TO COMPENSATE THOSE WHO SUFFER LOSSES FROM ACCIDENTS, ILLNESS, OR DEATH. When you own an insurance policy, you become a policyholder. Insurance companies "pool" policyholders' money through premiums paid to them. When a policyholder suffers a covered loss, he or she can file a claim with the insurance company to collect money for the damages.

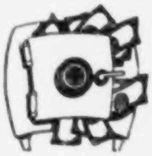
Example:

One thousand men, living in a small town, want to provide a continuing income for their families should they suffer a premature death. The town's current statistics, based on what has happened in the past, show that five men out of the one thousand will die each year.

The men decide to each contribute $50 per month, or $600 a year, to a general fund that will be given to the families of those who die. In one year, their "pooled" money equals $600,000. That sum is enough to pay $120,000 each to the five families who lose their breadwinner.

The men had a great idea, but ran into numerous problems doing the supervision among themselves. It was a big job to collect $50 monthly from each of them and keep accurate records of when they made their payments. Also, someone had to put the money where it was safe and take charge of paying the claims. They had to keep having meetings to answer questions that came up, such as:

- How should they handle late payments?
- If fewer men died in one year than expected, did they refund the extra money, or save it for a year when their death claims increased?
- If more men died than the expected number, should they pay a lesser amount, or assess all the members more money to pay the agreed amount?
- Should the money be placed in a safe until needed, or should they invest it?
- What responsibility did the manager have for investing their money? How much investment risk could he take?



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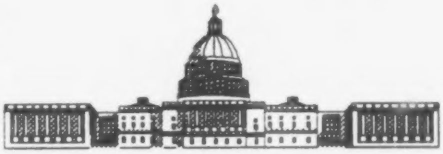
Collecting premiums, paying claims, and setting fair standards took full-time administrators. These administrators eventually formed the insurance companies that solved many questions and set standards for the insurance industry as we know it today. As more people bought insurance, the "pooled" money grew, and the earnings of the insurance companies also grew. This raised new questions. After paying all the claims and their administrative expenses, were insurance companies obligated to share these profits with their policyholders?

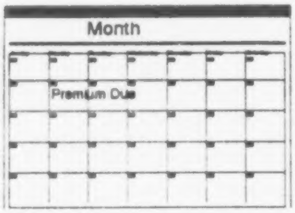
MANY PEOPLE SOON SAW THE ADVANTAGES OF POOLING THEIR FUNDS TO INSURE PROPERTY, HEALTH, AND DISABILITY AS WELL AS THE LOSS OF LIFE. AS MORE PEOPLE PARTICIPATED, INSURANCE BECAME BIG BUSINESS. Politicians got involved and made laws to regulate the industry and to protect the policyholders. These laws became the insurance code of each state. Each state's insurance code now regulates the insurance industry within that state. The state insurance code sets requirements for financial responsibility and establishes the guidelines that govern insurance companies in what they can and cannot do.



Although each state regulates the insurance companies doing business within their boundaries, the companies must adhere to certain national and industrial standards, such as:

Insurance companies must adhere to national and industrial standards

- Life insurance policies allow a thirty day grace period for late payments before they let a policy lapse.
- If a policyholder has been truthful and paid all premiums when due, the company must pay the claim.
- Upon the death of the insured, life insurance companies must pay the face amount of the policy regardless of how many death claims are filed that year.
- Life insurance companies cannot assess more than the agreed premium, even when they have more death claims to pay than they anticipated.



HEALTH AND DISABILITY INSURERS AND PROPERTY AND CASUALTY COMPANIES WILL CANCEL A POLICY IF THEY DO NOT RECEIVE THE PREMIUM BY THE DUE DATE. If policyholders let their policies lapse due to late payments, the company does not have to reinstate them upon receipt of the late payment. **AT EACH RENEWAL PERIOD, INSURANCE COMPANIES CAN RAISE THEIR RATES ON HOMEOWNER'S, HEALTH, DISABILITY, AND AUTOMOBILE POLICIES.** They often do when they have more claims to pay.

If insurance companies pay fewer claims than expected, they do not refund the extra money to their policyholders. They save the money to cover future claims or consider it "profit." Premiums paid are protection against uncertainty, not an investment that will give you a return.

Premiums are protection against uncertainty

They are not an investment that will give you a return

Insurance Commissioner

EACH STATE HAS AN ELECTED INSURANCE COMMISSIONER WHO OVERSEES THE INSURANCE INDUSTRY, MAKING CERTAIN COMPANIES AND LICENSED AGENTS COMPLY WITH THE STATE INSURANCE CODE. The commissioner has a major responsibility to check out a company's financial responsibility. Every insurance company that does business in the state, and all products offered by that company must have the commissioner's approval. Regulations do vary from state to state. A product approved in one state may not be approved in another state. The commissioner also oversees licensing procedures for insurance agents. He or she issues the licenses, and sets the ongoing educational requirements for license renewal.

In addition, the commissioner handles complaints and sets penalties for agents and companies who violate the insurance code. These violations usually occur when agents or literature misrepresent a product. The improper handling of premiums or not paying claims as agreed are other serious violations. The commissioner can impose heavy penalties or fines and/or revoke the licenses of companies and agents who repeatedly commit violations.

State Insurance Commissioner

- Approves insurance companies and their products
- Licenses agents
- Handles complaints
- Sets penalties for violators

Insurance Agents

YOU CAN BUY AN INSURANCE POLICY ONLY FROM LICENSED INSURANCE AGENTS. These agents must pass a test to get their license, and once licensed can sell life and disability products, or property and casualty products. Some agents are licensed to sell both. They receive commissions for the policies they sell and service. Their ongoing educational requirements update them on changes in the insurance code and keep them abreast of changes in their product line.

A GOOD AGENT WILL KEEP YOU INFORMED OF INDUSTRY CHANGES AND WILL WORK TO SAVE YOU PREMIUM DOLLARS. When you have questions about coverage, claims, or premiums, call your agent for information and advice.

A good agent will work to save you premium dollars

Agents often compete for your business. If a new agent offers you a new policy for considerably less money, make sure you have all the facts before switching policies. Many policyholders go with a new company that offers better rates, then later find out they bought inferior coverage. It is a good idea to call the writing agent on your original policy before switching. This agent might know details about the new policy that you never considered.

Self-Insurance

"Self-insurance" refers to the amount you personally can afford to pay to cover a loss of life, a loss of property, an illness, or an accident. You can reduce your premium dollars if you take it upon yourself to provide a certain amount of self-insurance.

Example:

If your medical insurance has a $500 or $1,000 deductible instead of a $100 deductible, your premium will be much lower. The higher deductible is your self-insurance amount. It represents the sum you are willing to pay each year to have lower premiums. The same concept applies to homeowner's and automobile policies because higher deductibles (the amount you pay) reduce your annual premium.

If you have money in savings or investments that your family can liquidate should you die, that extra money can be your "self-insurance." It will reduce the amount of life insurance you need to replace your income. Likewise, having less insurance requires a lesser premium.

Premiums

The fortunate ones, those who never have to file a claim, never collect on the premiums they have paid for pure insurance. Insurance companies use premium money to pay current claims. PREMIUMS BUY PEACE OF MIND; THEY PROTECT YOU, YOUR FAMILY, AND YOUR BUSINESS AGAINST FINANCIAL LOSS SHOULD UNFORTUNATE ACCIDENTS, ILLNESS, OR DEATH OCCUR.

The fortunate ones never collect on the premiums they have paid for pure insurance

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PART IV. Protection

You never know when you may die, become disabled, or get sick. If you own a home, it is subject to destruction by violent weather or fire. This could mean losing all of your personal possessions. Automobiles can be completely demolished through an accident. Along with the accident, if another person is hurt or killed by your automobile, you could be sued for the damages. The payment of insurance premiums give you protection against all of these perils. Insurance is a financial guardian for unknown future tragedies that could happen.

Insurance is a financial guardian for unknown future tragedies that *could* happen

Protection

LIFE INSURANCE pays a sum of money for the loss of a life. The types of policies and the amount of protection you might need, if any, is covered in the Chapter 12. Chapter 13 then goes into **HEALTH and DISABILITY INSURANCE.** Many workers have health coverage as a fringe benefit paid through their employers. They may or may not have a choice of plans. This chapter will help you better understand your health insurance policy if you have one, or guide you to the best type of policy to purchase if your employer does not pay for it. Most workers do not have adequate disability protection.

HOMEOWNER'S and **RENTER'S INSURANCE** as well as **AUTOMOBILE INSURANCE** come under Property and Casualty Insurance, the topic for Chapter 14. You will read about the importance of protection and available options for your policies.

Chapter 12

Life Insurance

LIFE INSURANCE PROTECTS DEPENDENTS FROM LOSS OF INCOME WHEN THEIR PROVIDER DIES. It also can protect a business when a valued employee dies. The proceeds from life insurance "replaces" the insured's future earnings or business skills.

> **The proceeds from life insurance "replaces" the insured's future earnings or business skills**

Life insurance sold to businesses covers the life of an important person in the organization. The insurance proceeds make it possible for the business to buy the deceased's outstanding stock and/or replace his or her professional skills by hiring another professional.

POLICY TERMS AND CONDITIONS

Life insurance policies are contracts between the **INSURER** (the insurance company) and the **POLICYOWNER** (the one who pays the premiums), for the benefit of the **BENEFICIARY** (the one designated to receive the money). The **INSURED** (the person covered) may or may not be the policyowner. **THE INSURANCE COMPANY PROMISES TO PAY THE FACE AMOUNT OF THE POLICY WHEN THE INSURED DIES, OR WHEN THE POLICY MATURES, AS LONG AS THE INSURED KEEPS THE POLICY IN FORCE BY MAKING THE REQUIRED PREMIUM PAYMENTS.**

Exclusions and additions to the basic policy must be in writing and made a part of the policy. **ALL ADDITIONS AND EXCLUSIONS TO A COMPANY'S BASIC POLICY MUST BE BROUGHT TO THE ATTENTION OF THE INSURED FOR APPROVAL.**

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An INCONTESTABLE CLAUSE, found in all policies, states that after the policy has been in force for a certain time, usually one to two years, the insurance company cannot void the policy except for nonpayment of premiums. If the insurance company discovers fraud because the applicant lied on a material point, they can cancel during the contestable period. Once the period ends, however, the company cannot void the policy even if the applicant committed fraud.

Once a policy has been in force for a certain time period, the insurer can only cancel for nonpayment of premium

Most state laws require that an insurance company have a GRACE PERIOD. THEY MUST GIVE THE POLICYOWNER A STATED TIME (USUALLY THIRTY DAYS) TO MAKE A PAST-DUE PREMIUM PAYMENT BEFORE THEY CANCEL THE POLICY.

A life insurance company only issues a policy if the beneficiary has an insurable interest in the life of the insured. To have an INSURABLE INTEREST, the beneficiary must suffer an economic or emotional loss upon the insureds death. Usually, an insurable interest does not exist between friends, cousins, aunts, or uncles. RELATIONSHIPS THAT HAVE AN OBVIOUS INSURABLE INTEREST INCLUDE: HUSBAND AND WIFE, PARENT AND CHILD, CREDITOR AND DEBTOR, AND BUSINESS PARTNERS. YOU ALWAYS HAVE AN INSURABLE INTEREST IN YOUR OWN LIFE.

An insurable interest is an economic or emotional loss upon the insureds death

If the policyowner is not the insured, it is up to the insurance company, based on information provided by the insurance agent, to make certain that an insurable interest exists between them before issuing a policy. ONCE THE POLICY IS ISSUED, AND KEPT IN FORCE WITH PAID-UP PREMIUMS, THE INSURANCE COMPANY MUST KEEP THEIR END OF THE BARGAIN AND PAY THE FACE AMOUNT AT THE DEATH OF THE INSURED. They can only cancel if they discover fraud during the contestable period.

Law requires life insurance companies to always pay the **face amount** of the policy. It doesn't matter how many death claims have been filed during the year or how long the policyowner has paid premiums—three months or fifty years. An attractive feature of life insurance is that the beneficiary receives the death benefit completely free of income tax. No other alternative will provide an immediate, tax free cash settlement for the loss of a life.

Life insurance provides an immediate tax fee estate

Underwriting

THE PROCEDURE OF APPROVING A PERSON'S HEALTH CONDITION IN ORDER TO ISSUE A LIFE INSURANCE POLICY IS CALLED UNDERWRITING. When applying for life insurance, you may or may not need a complete med-

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ical exam before the company issues the policy. OFTEN, A PARAMEDIC WHO COMES TO YOUR HOME COMPLETES THE REQUIRED EXAM. THE EXTENT OF THE EXAM VARIES ACCORDING TO AGE, TYPE OF POLICY REQUESTED, AND THE AMOUNT OF COVERAGE APPLIED FOR. Insurance underwriters normally require urine specimens and detailed answers to their health questionnaire before they approve an application for insurance.

The company considers a person with a preexisting health problem a higher risk. STANDARD RISKS PAY THE NORMAL PREMIUM. THE HIGHER RISKS OR SUBSTANDARD RISKS PAY HIGHER PREMIUMS ACCORDING TO THEIR SUBSTANDARD RATING. Insurance companies automatically consider smokers substandard risks and charge them higher premiums than nonsmokers. SOMETIMES, IN ORDER TO VERIFY A PERSON'S HEALTH CONDITION, THE UNDERWRITERS AT INSURANCE COMPANIES ORDER MEDICAL RECORDS FROM VARIOUS DOCTORS AND HOSPITALS.

People who are higher risks pay higher premiums

Mortality Tables

Mortality tables show how long people are expected to live. The information comes from statistics gathered over past years showing the ages of the people who died. For example, the insurance commissioner's current mortality table might state that out of every 1,000 persons, 1.90 died at age 20 and 16.08 died at age 60.

Mortality tables show how long people at various ages are expected to live

Mortality tables show the number of people who died within each age group. These tables decide the cost of insurance. SINCE FEWER PEOPLE DIE IN THEIR EARLY YEARS, THE COST OF INSURANCE IS CHEAPER FOR YOUNGER PEOPLE. STATISTICS SHOW THAT THE DEATH RATE INCREASES AS PEOPLE AGE, SO EACH SUCCEEDING YEAR THE COST OF LIFE INSURANCE INCREASES.

GROUP INSURANCE

During the enrollment period, group plans insure all members without a medical exam

Private businesses and federal, state, and local governments usually offer group life insurance to their employees. IN THIS CASE, ONE POLICY COVERS THE GROUP OF PEOPLE. THE INSURANCE COMPANY DETERMINES THE PREMIUMS BY THE GROUP'S OCCUPATION AND ITS AVERAGE AGE. The insurance company will admit all members of the group without a medical exam during a specified enrollment period. Most group

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plans only allow members to make changes or allow new members to enroll during a designated time of the year. **GROUP INSURANCE USES DECREASING TERM POLICIES, DISCUSSED ON PAGE 164.**

HOW MUCH LIFE INSURANCE DO YOU NEED?

Considerations

Do you have loved ones who are dependent upon your income? Would they suffer financial hardship if you should die prematurely? If so, you need life insurance. **THE AMOUNT OF LIFE INSURANCE YOU NEED DEPENDS UPON HOW MUCH INCOME YOUR FAMILY WILL REQUIRE IF YOUR EARNINGS SUDDENLY STOP.** You need to consider:

- **THE MONEY YOUR SPOUSE OR FAMILY COUNTS ON FROM YOU EACH YEAR TO MEET LIVING EXPENSES.** Many insurance representatives use 75% of the family's current income as a benchmark when advising their clients how much insurance they need to purchase. If you have children, look at how much money your surviving spouse will need to raise and educate them.

- **CONSIDER YOUR SPOUSE'S SALARY. IF YOUR SPOUSE IS NOT CURRENTLY WORKING, LOOK AT HIS OR HER EMPLOYABILITY.** Would it be "easy" for your surviving spouse to find a job, and if so, what is the potential salary? If you have small children and your spouse is not working full-time now, your spouse will need additional funds for child care.

- **THEN, LOOK AT THE MONTHLY BILLS YOUR SURVIVING SPOUSE WOULD HAVE TO PAY.** If you have many bills, such as car loans and other credit payments that could be a burden, consider sufficient insurance to pay them off in a lump sum upon your death.

- **NEXT, LOOK AT YOUR LIQUID ASSETS. THEY CAN BE USED AS "SELF-INSURANCE" TO REDUCE THE AMOUNT OF INSURANCE YOU NEED TO PURCHASE FROM A COMPANY.** For instance, if you decide you need $200,000 of life insurance, but you have over $50,000 of liquid assets, reduce the amount of insurance you need to purchase by $50,000.

- **FINAL EXPENSES INCLUDE FUNERAL, BURIAL FEES, AND HOSPITAL AND DOCTOR BILLS NOT COVERED BY INSURANCE.** Add an estimate for these charges to the total money needed by the surviving spouse.

- **SUBTRACT FROM THIS 'NEEDED' INCOME THE AMOUNT YOUR SURVIVING SPOUSE WOULD RECEIVE FROM YOUR EMPLOYER'S GROUP LIFE INSURANCE PLAN (IF ANY) AND FROM SOCIAL SECURITY (IF ANY).**

Social Security Benefits

Social security benefits for surviving family members vary according to the wages and contributions the deceased member made during his or her lifetime. For the family to qualify for benefits, the covered member must be "fully" or "currently" insured. "Fully" insured generally means at least forty quarters of contributions (ten years worth), and "currently" insured means at least six quarters of contributions during the most recent thirteen quarters.

Your spouse or divorced spouse, under age 60, can receive benefits only if he or she cares for a child under age 16, or cares for a child who was disabled before age 22. Children under age 18 (19 if still in high school) or those disabled before age 22 qualify for additional benefits. All family benefits are subject to certain income limitations.

Example Cases: Need for Life Insurance

To help you evaluate your need for life insurance, compare your situation with the following three cases. Keep in mind that recommendations may differ based on personal preferences.

CASE A

Jean and Dennis have no children. Both work and each earns approximately $35,000 a year. They have no debt except their $800 monthly house payment. Their total monthly living expenses are $1,500. They own stocks and mutual funds worth $40,000 and have $15,000 in a bank C.D.

RECOMMENDATION:

Neither of them need life insurance because the survivor would suffer no financial hardship. The salary for either, combined with their assets, would more than cover current expenses. Owning life insurance on each other, however, would increase their options while dealing with the trauma of losing a spouse. It is difficult to work when emotionally distraught, and the proceeds from the life insurance could fund a sufficient recovery period.

CASE B

Mike and Louise have two teenagers. Louise's annual salary is $40,000; Mike's is $25,000. Louise has a $75,000 group policy with her employer; Mike has no coverage. Their monthly house payment is $1,100, and their outstanding debt, including car loans and credit cards, equals $1,150 monthly. Each month they spend between $3,000 - $3,200 for their house payment, upkeep, utilities, car payments, bills, food, clothing, and recreation.

RECOMMENDATION:

Should either Mike or Louise die, the other would have a difficult time keeping up with their monthly payments with the increasing costs of raising their children. They both need insurance policies to protect each other, at least until they accumulate some savings or investments and reduce their debts.

If Mike should die, Louise wants to keep working. She feels it would be difficult to raise the children, send them to college, and continue their present lifestyle without Mike's income. A $125,000 policy on Mike would give Louise an annual $12,500 income that would last for fourteen years if the $125,000 earned a consistent 5% (see *How Long Will Your Money Last?*, in the Appendix).

If Louise had a $150,000 life insurance policy in addition to her $75,000 group life, this $225,000 would give Mike and the children an additional $24,750 a year for twelve years if the $225,000 principal earned a consistent 5%. This amount, combined with Mike's salary would be sufficient to pay final expenses, continue payments on their ongoing bills, and provide extra money for the children to go to college.

CASE C

Jay and Maxine have four children. Jay's current salary is $30,000. Their only monthly debts are their house payment of $600 and their car payment of $150. They spend approximately $1,700 monthly for living expenses, including their house and car payments. Maxine is a homemaker and has never been employed.

If something happened to Jay, Maxine would not have enough money to provide for herself and the children. Since she has never worked, getting a job and working on top of raising their four children would be difficult.

Jay is fully covered by social security according to current social security tables and the amount Jay has contributed to the system. In the beginning, Maxine and the children could receive up to $1,200 a month in family benefits. Then, as each child reaches sixteen years of age, Maxine's payment would be reduced with the child's benefit ceasing at age 18. Once the last child reaches age sixteen, Maxine would not be eligible for further benefits until age sixty.

RECOMMENDATION:

Social security alone would not be enough for Maxine to keep up with current living expenses. She would need at least $500 more each month along with $5,000 for expected final expenses. An $85,000 insurance policy on Jay would give Maxine $567 monthly, if the money earned 8%. With a policy this size and with earnings of 8%, Maxine would not need to dip into the principal of $85,000 in order to meet her family's ongoing living expenses. But, if the money earned only 5% she would need a $120,000 policy to receive $500 each month and also preserve the principal ($120,000 at 5% earns $6,000 annually, or $500 monthly). Alternatively, the $85,000 policy earning 5% and with Maxine withdrawing from the principal at 8% (see *How Long Will Your Money Last*, Appendix A) would give her $6,800 annually, or $567 monthly, for twenty years. After the children get older, unless Maxine could go back to school and learn a marketable skill so she could work and support herself, a larger sum of insurance would be needed to fund Maxine's living expenses after the family support from Jay's social security benefits stop.

In this case, insurance on Maxine is also important. If anything would happen to her, Jay would have to pay an additional $300 each month for child care in order for him to keep working. Maxine needs $45,000 of coverage with Jay named as the primary beneficiary to cover child

care expenses should she die. To save premium dollars, she can be added as a rider to Jay's policy (adding riders is discussed later in this chapter).

For your own situation, first decide if you need life insurance. Then, look at the minimum coverage required by your survivors to avoid financial hardship. Next, get several quotes from different insurance agents for the same basic coverage. Be sure to compare "like" policies: term with term, universal life with universal life, etc.

THE AMOUNT OF LIFE INSURANCE YOU NEED WILL BE BASED UPON:

- ✓ What you can **afford for premiums**
- ✓ **Assets** that your surviving spouse can liquidate
- ✓ The amount needed for ongoing family **living expenses**
- ✓ The continuing payments on your **monthly bills** and other **obligations**
- ✓ Expected **final expenses** (funeral / burial) not covered by insurance
- ✓ How much your **surviving spouse** will earn if he or she **works**. Will he or she need extra money for child care?
- ✓ Expected benefits receivable under **group plans** and **social security**

TYPES OF POLICIES

Some insurance contracts require higher premiums, but include a built-in savings plan. Others have lower premiums and are for "pure" insurance without the savings option. In both types of policies, you can add to their coverage by purchasing riders.

THE COST OF LIFE INSURANCE FOR YOUNG PEOPLE IS INEXPENSIVE BECAUSE SO FEW DIE; BUT, THE COST OF INSURANCE PREMIUMS FOR OLDER PEOPLE IS VERY EXPENSIVE BECAUSE FAR GREATER NUMBERS DIE EACH YEAR. ALL INSURANCE POLICIES HAVE ONE SIMILARITY; EACH YEAR THAT A PERSON GETS OLDER, THE COST OF INSURANCE GOES UP. This fact is true in every contract. If the premiums do not get higher, it is because you have "prepaid" the increases through higher premiums in the earlier years, or because the coverage decreases.

The cost of insurance increases with age

Most differences between policies are created by the way the insurance contract treats the excess premium a policyowner pays to the company. Pure insurance among different carriers is similar.

TERM POLICIES

Term insurance premiums are for "pure" insurance. These policies do not have attached savings account provisions. Term insurance is offered for a specified time, after which it is subject to renewal or termination. Term premiums are lower because the insured pays only for insurance coverage, nothing more. Each year that the insured grows older, the premiums increase. Most people who buy term insurance plan to keep the policy only until their children leave home or until they accumulate sufficient assets to self-insure.

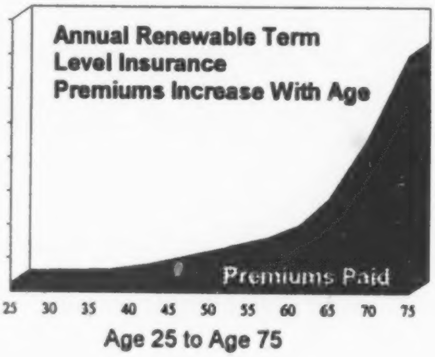
TERM POLICIES INCLUDE:

☆ **ANNUAL RENEWABLE TERM**
☆ **DECREASING TERM**
☆ **LEVEL TERM**
☆ **DEPOSIT TERM**

A definition of these policies, plus the advantages and disadvantages of each policy follows.

Annual Renewable Term

AN ANNUAL RENEWABLE TERM (ART) POLICY HAS A LEVEL FACE AMOUNT WITH INCREASING ANNUAL PREMIUMS. THE POLICY MUST BE RENEWED EACH YEAR, AND THE COMPANY MAY REQUIRE NEW PROOF OF INSURABILITY BEFORE IT DOES RENEW. Since we never know when or if we will become ill, and through the illness may then become a higher risk or even uninsurable, new proof of insurability in the future is an important consideration.



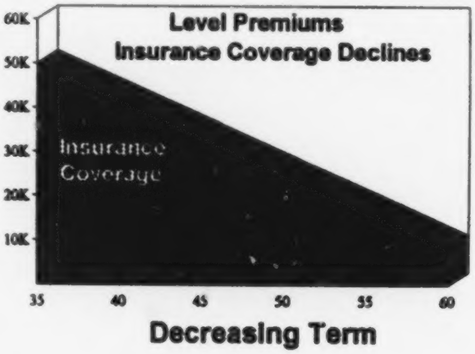
MOST ART POLICYHOLDERS CANCEL WHEN THEY GET OLDER AND THEIR PREMIUMS START TO SKYROCKET. For example, a male age 30 who is a nonsmoker and in excellent health would pay $145 for $100,000 of term coverage. At age 50, the premium could be $418 annually, and by age 65 it could have risen to $1,350. Those who succeed in saving and investing can "self-insure" in other investment and savings accounts so they can drop the policy by the time the premiums become "unaffordable." Having no insurance later in life is not detrimental for these "savers" because they have adequate liquid assets in other accounts to provide equal protection.

ADVANTAGES OF ANNUAL RENEWABLE TERM: ART gives the highest coverage for the lowest premium. Due to low mortality rates, the premiums are affordable for young to middle-aged persons.

DISADVANTAGES OF ANNUAL RENEWABLE TERM: Later in life, if the insured develops a chronic illness such as diabetes or heart disease, he or she may become uninsurable or have such high premiums that coverage is prohibitive. Some ART contracts allow renewal without evidence of insurability, but with most companies, this option expires around age forty-five. ART has no living benefits and no cash values.

Decreasing Term

DECREASING TERM HAS LEVEL PREMIUMS, BUT THE AMOUNT OF COVERAGE DECLINES EACH YEAR. Group plans usually offer this policy type because the group can pay the same premium amount for all members of the group. The premium is the same because the coverage varies. **WHEN THE GROUP CONTRACT STATES COVERAGE OF $50,000, OLDER MEMBERS DO NOT HAVE $50,000 OF COVERAGE; THEIR COVERAGE MAY BE ONLY $20,000 OR LESS.**

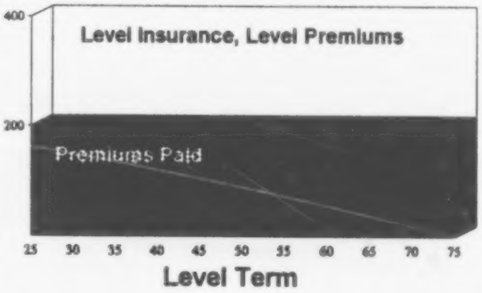


DECREASING TERM IS OFTEN SOLD AS MORTGAGE INSURANCE OR CREDIT INSURANCE. The coverage declines with the loan balance. Should the borrower die, the insurance pays off the loan. As the borrower retires the outstanding loan balance, the insurance coverage on the loan appropriately declines.

ADVANTAGES OF DECREASING TERM: Level premiums fit some needs. They are fair for group plans because employers can make equal contributions for all employees under the same policy.

DISADVANTAGES OF DECREASING TERM: The amount of coverage decreases every year. Older members of group plans have less insurance than the face amount of the policy. Younger members of the group often can get more coverage elsewhere for the same premium, since the premiums are based on the group's average age. As with other term contracts, no cash buildup exists.

Level Term



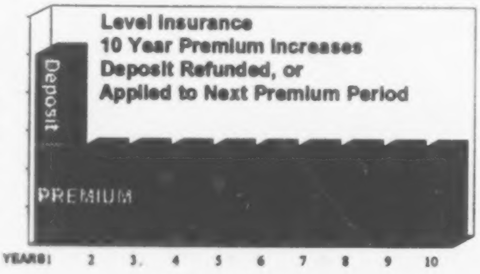
Level Term

LEVEL TERM WILL HAVE A LEVEL FACE AMOUNT AND LEVEL PREMIUMS THROUGHOUT THE LIFE OF THE CONTRACT. Since the "real" cost of insurance is less in the younger years, the company collects a double or triple premium in the early years of the policy. This extra money, with the interest it earns over those earlier years, helps to pay for the more expensive premiums as the insured grows older.

ADVANTAGES OF LEVEL TERM: Since the premiums are level, they remain affordable during the later years.

DISADVANTAGES OF LEVEL TERM: The insured must make certain the policy stays in force without new evidence of insurability. If the company periodically requires new evidence of insurability, the policyholder must assume that risk. The premiums are higher than ART during the early years when younger people are likely to have less money to spend on insurance. Since level term has no cash value buildup, the owners must have the discipline to develop a separate savings program.

Deposit Term



Deposit Term

DEPOSIT TERM PROVIDES LEVEL TERM COVERAGE FOR VARIOUS PERIODS SUCH AS FIVE, TEN, OR FIFTEEN YEARS, THE MOST COMMON BEING TEN YEARS. THE POLICY OWNER PAYS AN ADDITIONAL DEPOSIT AT THE BEGINNING OF THE CONTRACT PERIOD. The insurance company puts this additional deposit in a side fund to collect interest for the term of the contract. After the insured pays the first year's deposit and monthly premiums, the remaining premiums for the term period are level, and of course, much lower. When the period ends, the company returns the deposit plus interest to the insured, encouraging that it be used as a new deposit to buy insurance for another term.

ADVANTAGES OF DEPOSIT TERM: At the end of the designated period, the "forced" savings through the required deposit makes it easier to come up with the money needed to renew for another term. The level premiums throughout the term make continued payments easier.

DISADVANTAGES OF DEPOSIT TERM: If the policyowner does not pay the annual premiums for the full term, he or she loses the entire deposit. Typically, the first year deposit is usually double the annual premium, so this risk of loss is a significant disadvantage.

THE PREMIUMS FOR ALL TERM INSURANCE CONTRACTS BUY AFFORDABLE INSURANCE COVERAGE. THERE IS NO CASH VALUE BUILDUP AND NO RETURN FOR THE MONEY PAID IN. THE PREMIUMS PAID BUY PEACE OF MIND. THEIR SOLE PURPOSE IS TO PROTECT THE INSURED'S BENEFICIARIES AGAINST FINANCIAL LOSS IF THE INSURED DIES PREMATURELY.

PERMANENT POLICIES

All forms of permanent insurance include a savings provision, or cash value that comes from paying the higher premiums.

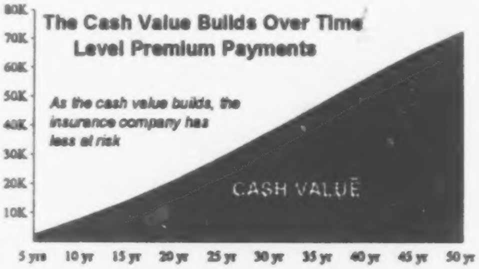
TYPES OF PERMANENT POLICIES INCLUDE:

☆ WHOLE LIFE
☆ MODIFIED LIFE
☆ LIMITED-PAY LIFE
☆ SINGLE PREMIUM LIFE
☆ UNIVERSAL LIFE
☆ VARIABLE LIFE & VARIABLE UNIVERSAL LIFE

A definition of each policy plus the policies advantages and disadvantages follows.

Whole Life

WHOLE LIFE contracts are permanent insurance. THE INSURANCE COMPANY SAVES A PORTION OF THE PREMIUM IN A SIDE FUND, WHICH BECOMES THE POLICY'S CASH VALUE. The side fund grows each year through compound interest earnings and additional payments made to the contract above the cost of insurance already built-in to the premium. THE INSURANCE COMPANY HAS MORE MONEY AT RISK WHEN THE CASH VALUE IS LOW. Then, as the cash value builds, they have less money at risk since the face amount they pay includes the cash value. For example, with a $100,000 whole life policy that has a cash value of $30,000, the insurance company is at risk for the difference, or $70,000. THE CASH VALUE IS ALWAYS USED TO PAY THE FACE AMOUNT. SO, AS THE CASH VALUE INCREASES, THE



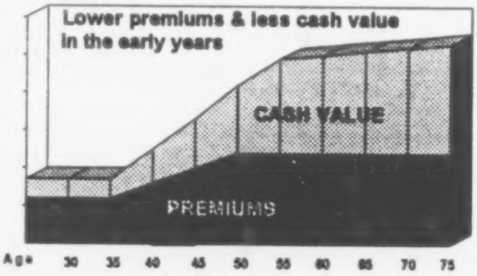
Whole Life

INSURANCE COMPANY HAS LESS AT RISK IN THE POLICY. The amount of coverage does not change unless the cash value exceeds certain limits. If this happens, federal guidelines require the face amount to also increase.

AS LONG AS THE POLICY IS IN FORCE, THE CASH VALUE BELONGS TO THE INSURANCE COMPANY. The insured must cancel the contract or borrow the cash value to receive it. In fact, if the policyowner borrows the cash value and does not pay it back, the insurance company subtracts the amount owed (principal plus interest) from the death claim paid to the beneficiary. For example, if a policyowner borrows $30,000 of their cash value at 5% interest from a $100,000 whole life policy, and does not repay the loan, the company will reduce the death claim by the $30,000 loan plus the accrued interest. At 5%, interest charges are $1,500 each year. So, in ten years, unpaid interest will reduce the face amount by an additional $15,000. The beneficiary would receive $55,000, not the $100,000 face amount. Loans from a whole life policy are not taxable. If the policy is surrendered, however, the gain over deposits is taxable.

Modified Life

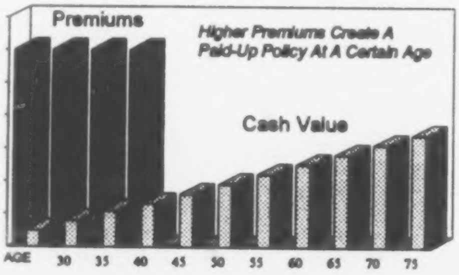
MODIFIED LIFE IS A VARIATION OF THE WHOLE LIFE CONTRACT. IT HAS LOWER PREMIUMS AND LOWER CASH VALUE DURING THE EARLIER YEARS. Then the premiums and, accordingly, the cash value increase during the "mid-earning" years when the owner's income is usually higher. This policy makes permanent insurance affordable for younger persons.



Modified Life

Limited-Pay Life

LIMITED-PAY LIFE is still another type of whole life. The policyowner pays higher premiums for a certain number of years, such as fifteen or twenty, so the policy becomes "paid-up" at the end of the designated term. The insurance remains in force until death with no further premiums due.



Limited Pay Life

Single Premium Whole Life

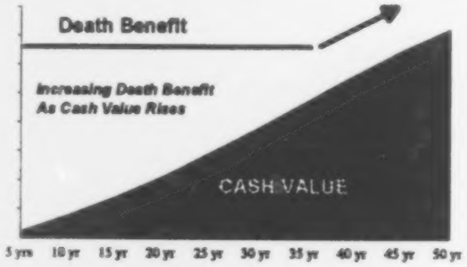
SINGLE PREMIUM WHOLE LIFE follows the same concept as limited-pay life. **THE ENTIRE PREMIUM IS PAID IN ONE LUMP SUM TO BUY A CERTAIN AMOUNT OF COVERAGE UNTIL THE POLICYOWNER DIES.**

Single Premium Whole Life

ADVANTAGES OF WHOLE LIFE: After several years of payments, the owner has a cash value in the insurance contract. If the policyholder stops paying premiums, the cash value must be paid to the policyholder or equivalent benefits must be provided (covered later under nonforfeiture options). Whole life has a living benefit which is the cash value available at termination of the policy or for borrowing. For those who don't have the discipline to save or invest, the whole life policy forces a savings plan.

DISADVANTAGES OF WHOLE LIFE: The premiums are much higher than those needed to purchase equivalent term insurance. With whole life, the policyowner also buys a savings plan. They do not own this savings plan, however, as long as the policy remains in force. To get their cash, they must borrow it from the policy or terminate the coverage.

Universal Life



Universal Life

UNIVERSAL LIFE IS THE MOST FLEXIBLE OF PERMANENT INSURANCE CONTRACTS. Universal life became popular in the early 1980s when rising interest rates made a mockery of the low interest earnings on whole life policies. Because insurance companies traditionally invested in long-term bonds with fixed interest rates, the side funds of their whole life contracts could not compete with the prevailing short-term interest rates fueled by rising inflation. Cash values were earning 3-4%, while the going money market rates were 12% - 14% and higher! Obviously, people wanted the higher rates. This situation forced the insurance industry to develop new, more flexible products, or lose their whole life business.

UNIVERSAL LIFE BECAME THE NEW PRODUCT, DESIGNED TO COMPETE IN THE CURRENT ECONOMIC MARKET. Universal life cash values were invested in short-term, less conservative investments allowing insurance companies to pay competitive interest rates. Variable universal life is also available for more aggressive investors.

INSURANCE COMPANIES DESIGNED UNIVERSAL LIFE POLICIES TO BE FLEXIBLE SO THE POLICY COULD ADAPT TO CHANGING LIFE SITUATIONS. ALTHOUGH CERTAIN CRITERIA MUST BE MET TO BE IN COMPLIANCE WITH FEDERAL TAX GUIDELINES, THE POLICYOWNER CAN PAY IN MORE MONEY, PAY IN LESS MONEY, OR EVEN STOP PAYMENTS WITHOUT CANCELING THE CONTRACT.

TAX GUIDELINES REQUIRE THAT THE DEATH BENEFIT AND THE CASH VALUES STAY WITHIN CERTAIN LIMITS. The law requires that the death benefit must also increase when the cash value reaches a certain level to maintain a certain ratio between the face amount of the policy and the cash value. **THE INSURANCE COMPANY MUST ALWAYS HAVE A CERTAIN PERCENTAGE AT RISK FOR THE PROCEEDS TO THE BENEFICIARY(IES) TO BE TAX FREE.**

As with whole life policies, a universal life contract owner may take a loan from the policy. The basis can also be withdrawn, and it is also nontaxable since it is a return of your own money. Such a withdrawal will reduce the insurance in the contract to a proportionate amount. This is an important concept when the owner uses the policy to provide tax free income.

ADVANTAGES OF UNIVERSAL LIFE: This contract has great flexibility and can be written to meet a policyholder's changing needs. The premiums can fluctuate with changes in income as long as enough is paid in to cover the "pure" cost of insurance and keep the coverage and cash account within the mandated guidelines. Companies invest the cash value, or side fund, in short-term investments that earn current interest rates. Many offer variable contracts with investments in stocks and/or bonds. Past performance of many of these funds has exceeded average interest rates. This may or may not be the case in the future. With a sizable amount in the side fund, a policyowner can stop payments and let the side fund pay the premiums. This pays the premiums with pretax dollars because the earnings on the side fund accumulate tax free. Another positive feature of universal life is the flexibility of the contract to raise or lower the death benefit to meet changing needs without switching to a new policy. This policy can also be used to supplement retirement income through policy loans and withdrawals from the policy.

DISADVANTAGES OF UNIVERSAL LIFE: Deposits going into the "cash" fund have a sales charge. For example, on every $100 paid in, the company will deduct a certain percentage, such as 6%, or $6, as a sales charge, so only $94 gets credited to the policyholder's account. Also, the owner must keep a specified amount of insurance to meet certain cash value levels. If the cash value increases substantially, the owner will need to buy more insurance to match the new higher cash value.

Variable Life and Variable Universal Life

VARIABLE LIFE and **VARIABLE UNIVERSAL LIFE** offer both fixed accounts and "separate" securities accounts. The separate accounts invest in stocks and bonds according to objective, similar to a mutual fund. **THE INSURED ASSUMES THE RISK FOR THE INVESTMENTS IN THE SEPARATE ACCOUNT.** The variable life policy provides higher equity based returns, and has a fixed premium and minimum guaranteed death benefit similar to whole life.

With **VARIABLE UNIVERSAL LIFE,** the level of the cash value, not the premiums paid, determines the death benefit. The cash value must stay at a certain level to keep the policy in force. The owner can take advantage of higher earnings but gives up a guaranteed cash value and a guaranteed death benefit. **THE POLICY IS WORTH WHAT THE INVESTMENTS EARN MINUS THE ADMINISTRATIVE FEES AND CHARGES.** For example, a variable universal life policy could decline in value during a bear market (declining stock market). Should the insured die during this period, the beneficiaries would receive the policy's value, not the face amount

On the other hand, if the investments owned by the variable universal life policy do well, the contract will show considerable gains over the traditional fixed account. In such a case, the cash value is always available to the policyowner and the insurance company always pays the full value of the policy to the beneficiaries.

Nonforfeiture Options

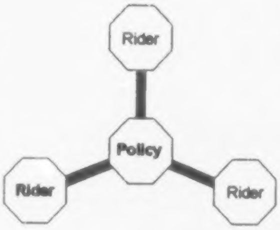
ALL PERMANENT INSURANCE POLICIES HAVE WHAT THE INDUSTRY CALLS NONFORFEITURE OPTIONS. THIS MEANS THAT SHOULD THE POLICY OWNER STOP PAYING PREMIUMS, THE COMPANY MUST MAKE THE CASH VALUE, OR ITS EQUIVALENT IN INSURANCE OPTIONS, AVAILABLE TO THE POLICYOWNER. The policyholder "elects" the options he or she prefers. The obvious choice is to surrender the policy for its cash value. Another alternative, however, is to purchase **REDUCED, PAID-UP INSURANCE.** You can instruct the insurance company to buy a single premium policy for a lesser amount with the cash value that has accumulated in your "lapsed" policy. Here the insured will have a lesser amount of coverage paid to a certain age.

EXTENDED TERM is still another option. In this option the company uses the cash value to buy term insurance *equal to the prior policy's face amount.* The number of years the insured has coverage depends upon his or her age and the accumulated cash value of the lapsed policy.

If a policy with a cash value lapses due to nonpayment of premiums beyond the 30 day grace period, the extended term provision automatically goes into effect unless the policyowner notifies the insurance company that he or she elects another option, such as taking the cash, or reduced paid-up insurance.

POLICY ADD-ONS: RIDERS

Additional coverage added to an original policy is called a rider. The premium increases with the addition of these riders, but riders often provide the least expensive way to get additional coverage. Riders can cover additional persons other than the insured. A company can add riders to any of its standard policies.



Term Rider

This adds an amount of level or decreasing term insurance to the policy. Policyowners often use this rider to purchase insurance for their spouse or other family members. To save premium dollars, add coverage for a spouse as a term rider.

Example:

If you want a $100,000 universal life or whole life policy on both a husband and a wife, have the agent write:

1) A $50,000 policy on the husband and add the wife with a $50,000 term rider, and

2) A $50,000 policy on the wife and add the husband with a $50,000 term rider. This will give $100,000 coverage for both persons and save premium dollars.

Children's Term Rider

This rider covers children, usually through age twenty-four, for amounts ranging from $1,000 to $20,000 per child.

Family Income Rider or Family Maintenance Rider

Purchasing this rider guarantees a monthly income if the insured becomes disabled or suffers a major illness and is unable to work. The amount paid and the time period for the payments depend upon the details outlined in the rider.

Guaranteed Insurability Rider

This rider guarantees that the insured can purchase more insurance at designated ages without new proof of insurability. With most companies, this option expires at age forty-five.

Waiver of Premium Rider

If the insured becomes totally and permanently disabled, the policy remains in force with no further premiums due. The policy will pay double or triple the face amount of the policy if the insured dies from an accidental death.

Disability Income Rider

If the insured becomes permanently and totally disabled, he or she can receive regular monthly income from the insurance company.

PERMANENT vs. TERM: WHAT SHOULD YOU BUY?

THE BEST INSURANCE POLICY FOR YOU DEPENDS UPON THE PREMIUMS YOU CAN AFFORD, THE AMOUNT OF COVERAGE YOU NEED, THE VALUE OF YOUR OTHER ASSETS, AND HOW MUCH DISCIPLINE YOU HAVE TO SAVE AND INVEST.

Decide on the type and amount of coverage you want, then compare several policies. While "shopping," you may want to tell the insurance agent how much you can afford for premiums and see what he or she recommends. You need someone who will be objective in assessing your needs and making recommendations.

THE BIGGEST DECISION WILL BE WHETHER YOU BUY TERM OR PERMANENT INSURANCE. Pros and cons exist for each type of policy, as illustrated in the following case histories.

Two Case Histories: Permanent Insurance vs. Term Insurance

TWO MALES, BOTH AGE THIRTY AND NONSMOKERS, WITH COMPARABLE INCOMES, BOUGHT $100,000 OF INSURANCE. LEE JOHNSON BOUGHT A WHOLE LIFE POLICY. TOM ALLEN BOUGHT ANNUAL RENEWABLE TERM AND SAVED THE DIFFERENCE BETWEEN THE WHOLE LIFE AND THE ART PREMIUM. LET'S LOOK AT EACH OF THEIR SITUATIONS TWENTY YEARS LATER AT AGE FIFTY.

Lee Johnson has paid premiums of $898 each year for his whole life policy. During the twenty year period, his total outlay for premiums was $17,960. The guaranteed cash value in his policy now equals $21,215. He has had the advantage of $100,000 of insurance for twenty years, and is ahead by $3,255 if he subtracts the premiums paid from the current cash value.

Lee has many options open to him. He can keep his coverage in effect by paying the same $898 annual premium and continue to build up his cash value until he retires, or he can borrow the cash value, or he can terminate the policy and receive the $21,215 in cash. He can also take advantage of the nonforfeiture options (see p. 170) by using the cash value to purchase a paid-up, extended term policy requiring no additional premiums, or a reduced, paid-up policy that will give him a lesser amount of coverage.

Tom Allen purchased annual renewable term insurance. Although he could afford the whole life policy, he did not want the insurance company to own his savings plan. Using the same dollar amount required to purchase a whole life policy, he bought the less costly ART, and saved the difference. His first year's premium was only $127 compared to the whole life annual premium of $898, so he saved $771. By the 10th year, his ART premium had risen to $190, so he still saved $708 that year. By the 20th year, he saved only $392 because his premium had grown to $506. Over the twenty years, Tom put the "excess premium" into an income fund that earned an average rate of 8%. By age fifty he had $34,507 in this fund. Tom also had $100,000 of insurance coverage during the past twenty years.

Tom's income fund can't be compared to the cash value in Lee's whole life policy without considering the tax consequences. With Lee's whole life policy, he has paid no income taxes on his cash buildup since it is tax free. Tom, however, has paid additional taxes each year on the interest and dividends earned on his income fund. In fact, over the twenty years he paid $9,413 in taxes on the fund's earnings. The after-tax value of his fund is therefore $25,094. Compare this to Lee's $21,215 whole life cash value.

Although Tom has full use of his income fund, he faces another problem that Lee does not have. His insurance premiums rise each year, so fewer "savings" dollars go into his income fund. By age fifty-seven, his premiums will be higher than the original $898 he planned to set aside. Since his insurance premiums increase each year and will be over $2,400 at age seventy, Tom most likely will let his policy lapse, and his beneficiary will lose out on the $100,000 death benefit.

Whether you should buy term or whole life insurance is a choice you will need to make. Pros and cons exist for each type of policy. If you are a disciplined saver and consistently put money aside that would otherwise be spent on premiums, you will come out ahead by buying term insurance and directly owning your savings plan. On the other hand, if you would not save or invest the difference in premiums between permanent and term insurance, owning a permanent policy gives you more options. Many people intend to invest the difference, but actually don't. When this is the case, a permanent plan will serve you better because it forces a savings plan that you would not otherwise have. Also, you must face the fact that as you get older term premiums may become unaffordable. Unless you accumulate equivalent savings and investments, your survivors could be left with little or nothing.

Insurance companies continually design new life insurance policies, but the following gives a summary of the most common permanent and term insurance plans. All are explained in this chapter.

Table 12.1 TYPES OF INSURANCE POLICIES

TERM	PERMANENT
Annual Renewable Term	Whole Life
Level Term	Universal Life
Decreasing Term	Variable Life and Variable Universal Life
Deposit Term	Single Premium Life
	Limited-Pay Life
	Modified Life

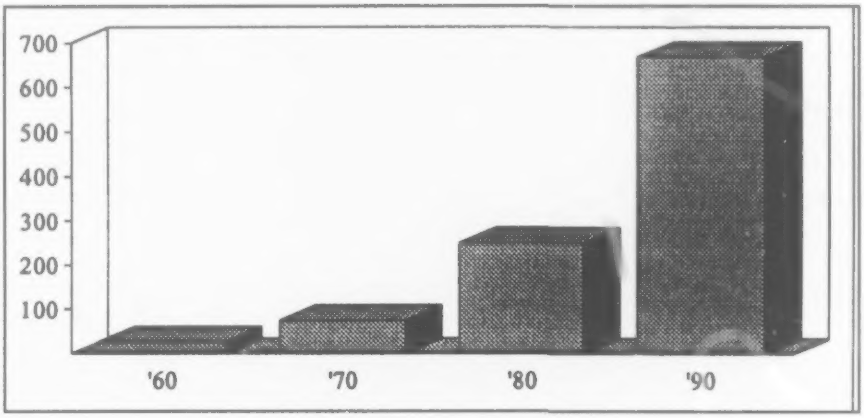
Chapter 13

Health & Disability Insurance

SOURCES FOR HEALTH INSURANCE

Health care costs have increased 266% during the past ten years. Chart 13.1 shows total U.S. health care expenditures since 1960.[18]

Chart 13.1 U.S. HEALTH CARE COSTS (in billions of dollars)



HEALTH CARE IS SO EXPENSIVE TODAY THAT, WITHOUT ADEQUATE COVERAGE, A MAJOR ACCIDENT OR ILLNESS COULD EASILY WIPE OUT ALL OF YOUR ASSETS. Health and disability insurance can provide financial protection against such misfortune. Sources for health insurance include:

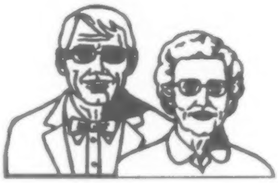
❶ EMPLOYER GROUP PLANS
❷ MEDICARE
❸ MEDICAID
❹ HEALTH MAINTENANCE ORGANIZATIONS
❺ PRIVATE POLICIES

EMPLOYER GROUP PLANS

Most employers offer excellent group plans, some with a choice of policies. **MANY EMPLOYERS PAY ALL OR A PORTION OF THE PREMIUM AS EMPLOYEE FRINGE BENEFITS.** Employers also contribute to a workers compensation fund that will cover their employees' medical expenses should they get injured on the job.

UNDER C.O.B.R.A., A CURRENT FEDERAL LAW, IF EMPLOYEES LOSE THEIR JOB, THEY CAN CONVERT AN EMPLOYER PROVIDED POLICY TO AN INDIVIDUAL POLICY WITH THE SAME INSURER AND CONTINUE THEIR COVERAGE. The premiums will be higher for the individual policy, but any preexisting conditions remain covered.

MEDICARE



Medicare is a health insurance program underwritten by the federal government. It is available for people age 65 and older, or those of any age who are permanently disabled. Medicare has two parts:

Part A *Hospital Insurance*

Hospital insurance pays for hospitalization and other associated costs.

Part B *Medical Insurance*

The medical insurance pays 80% of all covered medical costs after meeting an annual $100 deductible. Eligible persons pay a low monthly premium that is taken out of their social security check.

MEDICAID

MEDICAID IS A STATE PROGRAM THAT IS FEDERALLY FUNDED. It pays medical bills for low income people of all ages. Those who qualify for welfare automatically qualify for Medicaid. Eligibility and the extent of the paid medical expenses vary from state to state.

HEALTH MAINTENANCE ORGANIZATIONS (HMO'S)

HMO's provide policies to groups and to individuals. **HMO'S ARE USUALLY A LARGE GROUP OF DOCTORS AND OTHER MEDICAL SPECIALISTS OPERATING OUT OF A FULLY EQUIPPED MEDICAL FACILITY TO PROVIDE A FULL RANGE OF SERVICES.** These organizations offer total health care for a monthly fee. Services include doctor visits, hospitalization, prescriptions, physical therapy, vision, dental, emergency, outpatient, and home care services. HMO's eliminate the paperwork associated with filing medical claims.

With HMO's the quality of care varies in different locations and among different carriers. The insured must use one of the organization's member doctors and can only use certain authorized facilities. In many locations today, this limitation does not reduce the quality of the care received. In fact, an HMO may offer better care through streamlined diagnosis and doctor communication. For example, during your doctor's appointment, he might send you to have x-rays and lab work. You walk to another part of the facility for these tests and wait for the results. Then, you report back to your doctor who analyzes the tests and gives you a prescription. Alternatively, the doctor may immediately refer you to a specialist or to another doctor for a second opinion and you never leave the building. Thus, within one facility you take care of all phases of your examination and health care needs and never file an insurance claim.

Kaiser Permanente and FHP are two examples of popular extensive HMO's.

PRIVATE POLICIES

IF YOU CANNOT GET COVERAGE THROUGH YOUR EMPLOYER OR THROUGH A FEDERAL OR STATE INSURANCE PLAN, YOU NEED A PRIVATE POLICY. These are often the same policies offered by employees, but without the group's volume discount, you will pay more for equivalent coverages.

OTHER HEALTH POLICIES COVER ONLY SPECIFIC INCIDENTS AND SPECIFIC ILLNESSES. These include:

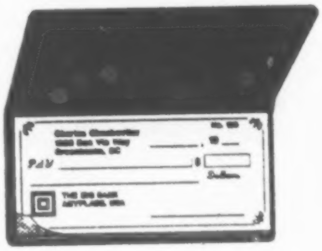
Medigap	Picks up benefits not covered by Medicare.
Dread Policies	Covers cancer or another specifically named illness; only the named illness is covered.
Hospital Indemnity	Covers only hospitalization; designed for supplementary coverage.
Long-term Health Care	Covers nursing home care not paid for by Medicare and Medicaid. Many policies include licensed nursing facilities as well as in-home care.

BE CAUTIOUS WHEN APPLYING FOR ONE OF THE SPECIFIC POLICIES NOT TO DUPLICATE COVERAGE ALREADY INCLUDED IN ANOTHER BASIC HEALTH PLAN IN WHICH YOU ARE ALREADY ENROLLED. Before you sign up, know what you are paying for, how much you are paying, and where the policy sets limits.

Know the policy limitations for all policies covering specific incidents & illnesses

MAJOR MEDICAL – BASIC HEALTH PLANS FOR GROUPS & INDIVIDUALS

BASIC HEALTH COVERAGE GIVES PROTECTION FOR ACCIDENTS, SHORT-TERM ILLNESSES, DOCTOR AND NURSE VISITS, LABORATORY TESTS, AND PRESCRIPTION DRUGS. MOST POLICIES HAVE A DEDUCTIBLE THAT IS PAID EVERY YEAR. These deductibles range from a low of $50 to a high of $5,000. The most common are $100 and $250. If given a choice, one deductible that applies to an entire family will cost less than a separate deductible for each individual family member.



MOST POLICIES HAVE A COINSURANCE CLAUSE. After the insured meets the annual deductible, the insurance company pays a percentage and the insured pays the remaining percentage of all future claims within that year. The most common is an 80/20 split, with the insurance company paying 80% and the insured paying 20% of the medical bills. A different coinsurance amount, such as 50/50, often applies to vision and dental care if they are included in the policy.

%

MAJOR MEDICAL IS THE MOST IMPORTANT MEDICAL COVERAGE TO OWN. It will pay most of the bills for a major illnesses or for extended hospital care. Practically all people can afford to pay for periodic visits to a doctor, but the costs associated with a major illnesses such as cancer, heart disease, or kidney failure would bankrupt the average wage earner. Surgery, hospital care, medical specialists, and postoperative treatments can generate bills exceeding $350,000. If you can only afford one type of health insurance, select major medical.

The insurance company pays 100% of all covered expenses once a policy reaches the stop loss clause

The better policies pay 100% of all medical expenses once the expenses reach a certain limit, such as $5,000 or $10,000. To take advantage of this feature, your policy must have a STOP LOSS CLAUSE. The insured's share of expenses stop after his or her out-of-pocket costs reach the stated limit such as $5,000 or $10,000. The policy explains the maximum you must pay before the stop loss clause goes into effect. From that point, the insured has 100% coverage for all continuing, approved expenses. **ALSO, MAJOR MEDICAL POLICIES HAVE A CAP OR POLICY LIMIT ON HOW MUCH THEY WILL PAY FOR EACH PERSON COVERED UNDER THE POLICY.** Once the insurer has paid out this amount, they pay no more. For most situations, minimum coverage should be $250,000. Many policies set their limit as high as $1,000,000.

Policies have limits on how much they will pay

BETTER COVERAGE FOR A MAJOR ILLNESS OR ACCIDENT COMES FROM A LOWER STOP LOSS CLAUSE (WHEN THE INSURANCE COMPANY STARTS PAYING 100% OF ALL MEDICAL COSTS) AND FROM A HIGHER POLICY LIMIT. THE AMOUNT PAID FOR THE ANNUAL DEDUCTIBLE AFFECTS PREMIUM'S PAID, NOT THE EXTENT OF THE COVERAGE.

The insured pays a deductible each year. As mentioned, these amounts range from $50 to $5,000. **IF YOU HAVE A PRIVATE POLICY, THINK OF THE DEDUCTIBLE AS THE AMOUNT YOU CAN AFFORD AS 'SELF-INSURANCE' SHOULD A MAJOR ILLNESS AFFECT YOU OR A COVERED FAMILY MEMBER.** The higher the deductible, the lower the premiums.

Higher deductibles mean lower premiums

Summary

Deductible	The amount you pay each year
Coinsurance	The insurance pays a percentage, you pay a percentage: i.e., 80% by insurance, 20% by you
Stop Loss Clause	Insurance pays 100% once expenses reach this limit
Policy Limits	Total amount the policy will pay

DISABILITY INCOME PROTECTION

DISABILITY OCCURS WHEN YOU ARE NOT ABLE TO PERFORM YOUR REGULAR JOB DUTIES. How a policy defines disability is very important. It may be defined as:

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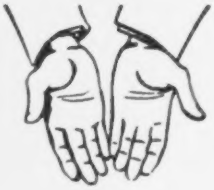
👍	**Unable to perform customary occupation**
👉	**Unable to perform related occupation**
👎	**Unable to perform any occupation**
👎	**Total hospital or in-house confinement**

Unless the policy covers disability in your regular occupation (in some cases a related occupation is O.K.), you are wasting your premium dollars. If you are a dentist, a surgeon, a construction worker, or a piano player with a significant hand injury, you cannot perform your regular job duties. An inferior disability policy might say you can still work by running a mail order business from your home and not compensate you for the injury. Avoid policies with such restrictive definitions.



PEOPLE OFTEN OVERLOOK DISABILITY INSURANCE, BUT IT IS IMPORTANT PROTECTION TO OWN. The ability to work and earn an income is a wage earner's greatest asset. **PEOPLE HAVE A GREATER CHANCE OF BECOMING DISABLED THAN OF HAVING THEIR CAR DESTROYED IN AN ACCIDENT OR HAVING THEIR HOUSE CATCH ON FIRE.** In fact, 3% of all mortgage foreclosures are due to death, but 48% are due to the mortgagee's disability.[illegible]

The ability to work and earn a living is a wage earner's greatest asset

Statistics Show That Every Year:

- ☑ 1 out of 106 people die
- ☑ 1 out of 70 people have an automobile accident
- ☑ 1 out of 88 households catch on fire
- ☑ 1 out of 8 people suffer some extent of disability

IF YOU HAVE GROUP HEALTH INSURANCE WHERE YOU WORK, YOU MAY BE ABLE TO ADD A DISABILITY RIDER. This is the most cost effective way to get disability protection. Some employers also offer separate disability policies.

A disability rider is the most cost-effective way to get disability protection

ALTHOUGH WORKERS WHO ARE FULLY INSURED WITH SOCIAL SECURITY HAVE DISABILITY INSURANCE, THE DEFINITION IS RESTRICTIVE. Chances are much greater of becoming partially disabled, and social security pays only for total disability. If you are diagnosed as totally disabled, payments start six months after a doctor declares the total disability and the payments will continue for the duration of the injury. The amount you receive depends upon your age, and current and past earnings (see *Social Security Benefits* in the Appendix). Workers who are injured on the job also have some disability coverage under the state worker's compensation fund.

The social security definition of disability is restrictive

Sources For Disability Insurance:
- ✓ Group Health Insurance
- ✓ Riders to Health & Life Insurance Policies
- ✓ Social Security
- ✓ Individual Policies
- ✓ Worker's Compensation
- ✓ Veterans Administration
- ✓ Civil Service
- ✓ Unions

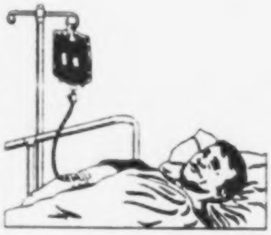
MOST INDIVIDUAL DISABILITY PLANS PAY 60% - 70% OF YOUR CURRENT SALARY AS LONG AS YOU ARE DISABLED. Disability policies rate their premiums according to the insured's occupation and waiting period required before they must commence payments. More hazardous occupations require higher premiums. The waiting period is your choice. You can select when you want to start receiving payments: 30, 60, 90, 120, 180, or 365 days after you become disabled. **THE LONGER WAITING PERIODS OFFER YOU AN EXCELLENT OPPORTUNITY TO USE SELF-INSURANCE TO REDUCE THE PREMIUM.**

Most individual disability plans pay 60%-70% of your current salary as long as you are disabled

THE FOLLOWING SHOULD BE INCLUDED IN A GOOD DISABILITY POLICY:

- A definition that will pay you if you cannot perform your "regular" job.
- Coverage of illness and accidents.
- Payments will continue for the duration of your disability and not stop after one year.
- Payments will be 60% - 70% of your present salary/earnings. The policy limits rise with salary or earning increases. The premiums also increase proportionately.
- Provides partial payments for partial disabilities.

The risk of some form of disability is great, so make sure you have protection. **PARTIAL DISABILITIES ARE THE MOST COMMON AND THE LEAST PROTECTED.** Your best option to save premium dollars is to add a disability rider to your health or life insurance policy. Only do so, however, if the policy's definition says it will pay if you cannot perform the functions of your regular job.



MEDICAL INSURANCE IS IMPORTANT PROTECTION. FEW PEOPLE TODAY CAN AFFORD TO PAY OUT-OF-POCKET FOR 100% OF THEIR HEALTH CARE COSTS, ESPECIALLY IF THEY SUFFER A MAJOR ILLNESS OR ACCIDENT. Premiums paid to insure or cover these potential costs are a wise investment. **LIKEWISE, A DISABILITY POLICY WITH A BROAD DEFINITION OF DISABILITY IS A WISE PURCHASE. IT WILL PROVIDE INCOME IF YOU ARE UNABLE TO WORK, THUS PROTECTING YOUR OTHER ASSETS.**

PROTECT YOURSELF FROM POTENTIAL FINANCIAL LOSS THROUGH OWNING:

- ✓ Major Medical Insurance
- ✓ Disability Insurance

Chapter 14

Property & Casualty Insurance

HOMEOWNER'S POLICIES

EMERGENCY
MEDICAL SERVICES

HOMEOWNER'S INSURANCE PROTECTS YOU FROM FINANCIAL LOSS SHOULD SOME DISASTER DESTROY ALL OR A PORTION OF YOUR HOME, ITS SURROUNDING BUILDINGS, OR ITS TREES AND SHRUBBERY. If your home is totally destroyed, the insurance also pays for living expenses in a temporary location. Homeowner's policies also can provide protection against ice damage, theft, and broken water pipes. In addition, the liability portion covers accidents that take place on your property. If your cousin's child falls through your glass patio door and breaks an arm, a comprehensive homeowner's policy will pay the medical bills for the broken arm.

Dwelling

You should always insure your property for 80% of its replacement value (not the market value). As long as you have insurance for 80% of the replacement value, you are automatically covered for 100% of the loss. As the replacement value rises, so should your insurance. **MOST POLICIES HAVE AN INFLATION FACTOR AND ADJUST THE REPLACEMENT VALUE AUTOMATICALLY EACH YEAR.**

Insure your property for 80% of its replacement value

Generally, companies offer three types of homeowners policies: HO-1, HO-2, and HO-3. Table 14.1 shows the perils covered under each type of policy. HO-1 is the basic policy with the lowest premiums and fewest perils covered. HO-2 covers more perils and HO-3 provides the most extensive coverage. The premiums increase with the perils covered.

Table 14.1 PERILS COVERED BY HOMEOWNER'S POLICIES*

	HO-1	HO-2	HO-3
1. Fire or lightning	✓	✓	✓
2. Removal of destroyed property i.e. clean-up after tornado	✓	✓	✓
3. Wind or hail	✓	✓	✓
4. Explosion	✓	✓	✓
5. Riot	✓	✓	✓
6. Damage by an aircraft	✓	✓	✓
7. Damage by a vehicle	✓	✓	✓
8. Smoke	✓	✓	✓
9. Vandalism	✓	✓	✓
10. Theft	✓	✓	✓
11. Glass breakage	✓	✓	✓
12. Damage from falling objects i.e. branch falls from tree onto roof during hurricane		✓	✓
13. Damage from weight of ice and snow		✓	✓
14. Building collapse		✓	✓
15. Hot water system heating damage		✓	✓
16. Damage to water pipes or A.C.		✓	✓
17. Frozen pipes, damage to appliances		✓	✓
18. Electrical wiring & fixtures		✓	✓
19. All perils except flood, war, earthquakes, etc. (see exclusions in your policy)			✓

**Source:* Insurance Information Institute*

IF YOU LIVE IN A FLOOD, HURRICANE, FIRE, OR EARTHQUAKE ZONE, YOUR BASIC HOMEOWNER'S POLICY WILL NOT COVER THESE DISASTERS. Furthermore, obtaining separate coverage for these catastrophes can be expensive. **PREMIUMS FOR EARTHQUAKE, FIRE, AND HURRICANE INSURANCE VARY DEPENDING ON WHERE YOU LIVE AND YOUR POTENTIAL EXPOSURE. CHECK THE EXCLUSIONS OF YOUR POLICY SO YOU KNOW WHAT IS COVERED. EXCLUSIONS VARY FOR DIFFERENT LOCATIONS.**

IF YOU LIVE IN A FLOOD ZONE, YOU CAN QUALIFY FOR MORE AFFORDABLE FEDERAL FLOOD INSURANCE. This coverage is offered through the insurance company, but guaranteed by the federal government. To qualify you must live in the home at least 80% of the time.

HOMEOWNER'S POLICIES HAVE DEDUCTIBLES THAT RANGE FROM $250 AND UP. THAT MEANS YOU WILL ALWAYS PAY THE FIRST $250 FOR EVERY CLAIM, REGARDLESS OF THE EXTENT OF THE LOSS OR THE NUMBER OF CLAIMS YOU FILE IN A YEAR. Policies with higher deductibles have lower premiums. A higher deductible saves money in the long run, because homeowners generally do not file claims often. **THINK OF THE DEDUCTIBLE AS THE AMOUNT YOU CAN AFFORD TO PAY FOR "SELF-INSURANCE." THE HIGHER DEDUCTIBLES HELP TO KEEP YOUR ANNUAL PREMIUMS LOW AND STILL PROVIDE PROTECTION AGAINST MAJOR LOSSES.**

You pay your deductible with every claim filed

Loss of Use

THE AMOUNT STATED ON THE POLICY IS THE MAXIMUM AMOUNT THE INSURANCE COMPANY WILL PAY FOR TEMPORARY LIVING EXPENSES. Payment is normally for the shortest time required to repair or replace the home, or settle elsewhere.

If you rent all or a portion of your home, this coverage also includes payment for the fair rental value until the property is repaired or replaced.

Personal Property and Renter's Insurance

PERSONAL PROPERTY COVERAGE IS USUALLY ONE-HALF OF THE TOTAL DWELLING COVERAGE. Rates do vary, so check your policy limits. Personal property includes appliances, clothing, furniture, rugs, jewelry and collectibles, etc. **RENTER'S INSURANCE IS BASICALLY PERSONAL PROPERTY COVERAGE.** It covers your furnishings and personal possessions within your apartment or condo.

Expensive jewelry, china, antiques, silverware, or furs, should be covered separately. **EACH INSURANCE COMPANY SETS A LIMIT ON HOW MUCH THEY WILL PAY FOR VALUABLES. USUALLY THE AMOUNT IS AROUND $2,500 TOTAL, WITH NO MORE THAN $1,000 FOR EACH ITEM UNLESS YOU REQUEST AND PAY FOR ADDITIONAL COVERAGE.**

Personal property is also insured when it is off premises. While traveling, your jewelry and clothing are insured. The coverage, however, is less. So, if you often travel with expensive items, contact your insurance agent and check the limits.

Cover valuables separately if they are worth more than $1,000 each

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Liability

THE LIABILITY PORTION OF A HOMEOWNER'S POLICY COVERS PERSONAL INJURIES TO OTHER PEOPLE WHEN THESE INJURIES TAKE PLACE ON THE PROPERTY. In some cases, the injured person sues the homeowner to collect their damages. The standard liability coverage on most homeowner's policies is $100,000. **IN ADDITION, MOST POLICIES OFFER INCREASED LIABILITY PROTECTION THROUGH AN UMBRELLA POLICY THAT WILL COVER ALL PERSONAL LIABILITIES UP TO $1,000,000.** Such an umbrella policy is usually a very good buy.

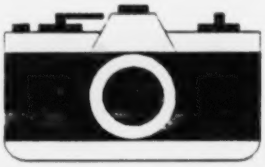
The liability portion of a homeowner's policy covers personal injuries to other people when these injuries take place on the property

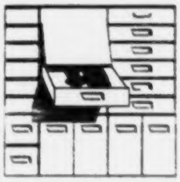
Filing a Claim

When damage occurs to a home or yard, or when you have items stolen, you need to file a claim. First, notify your insurance agent or the insurance company. They will send an adjuster to look at the damage and/or estimate the repair or replacement cost. If you have a theft, you need to file a police report and provide proof of the value of the stolen property.

When damages occur, do not attempt any repairs until the insurance adjuster estimates the harm, and you both agree on the amount to be paid by the insurance company. The insurance company expects you to protect the property from further damage. So, if you must do emergency repairs before the adjuster arrives, take pictures of the damage before doing the repairs and keep receipts of expenses.

Picture Inventory





PICTURES OF PERSONAL PROPERTY, ESPECIALLY THE EXPENSIVE ITEMS, HELP PROVE THEIR VALUE TO THE ADJUSTER IF THESE ITEMS ARE DESTROYED OR STOLEN. It is a good idea to take photos of all of your household belongings. If you own a video recorder, you can make a video tape. Also, you should separately appraise valuable works of art, collectibles, expensive jewelry, and furs to provide evidence of their worth. **KEEP ALL APPRAISALS AND PICTURES OF YOUR PERSONAL PROPERTY INVENTORY AWAY FROM YOUR PREMISES.** They could be left with a trusted family member or neighbor. Many people use a safe-deposit box. Taking such an inventory is easy and will be invaluable if you ever have to prove a loss.

If you and the insurance adjuster cannot agree on the amount of loss for personal property, the company will hire an appraiser. You may also hire an appraiser and the two sides will negotiate until they come to terms. **IF YOU HAVE EVIDENCE THROUGH APPRAISALS OR PICTURES OF YOUR VALUABLES, PROVING YOUR LOSS IS FAR EASIER.**

AUTOMOBILE INSURANCE

Automobile insurance offers three major coverages:

Liability	⟺ ⟺	bodily injury your car does to others property damage your car does to other vehicles and to personal property
Collision	⟺	damage done to your car
Comprehensive	⟺	glass breakage, theft, fire, damage from storms, etc.

Liability

AUTOMOBILE INSURANCE HAS TWO TYPES OF LIABILITY COVERAGE:

1. **BODILY INJURY**
2. **PROPERTY DAMAGE**

All drivers must carry bodily injury liability

LAW REQUIRES ALL MOTOR VEHICLE DRIVERS TO CARRY BODILY INJURY LIABILITY INSURANCE. The least amount of liability insurance you carry should be sufficient to cover your net worth. If your car injures or kills another person, the insurance company pays the damages up to the amount of the policy limits. If another person drives your car with your permission and has an accident, the injuries from this accident are also covered.

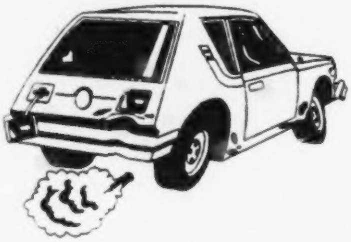
POLICIES SHOW BODILY INJURY LIABILITY IN TWO PARTS, such as: 15/30, 50/100, 100/300. All numbers are understood to be stated in thousands. **THE FIRST NUMBER IS THE MAXIMUM AMOUNT THE INSURANCE COMPANY WILL PAY TO ANY INDIVIDUAL IN EACH ACCIDENT, AND THE SECOND NUMBER IS THE MAXIMUM AMOUNT THE INSURANCE COMPANY WILL PAY FOR ANY ACCIDENT REGARDLESS OF THE NUMBER OF PEOPLE HURT.**

THE SECOND TYPE OF AUTO LIABILITY INSURANCE IS FOR PROPERTY DAMAGE. This covers damage your car causes to another's property. The property includes other cars, fences, houses, posts, buildings, and so on. Again, your policy covers other drivers as long as they have permission to use the car.

PROPERTY DAMAGE IS ALSO STATED IN THOUSANDS AND WRITTEN AS THE THIRD PART OF THE LIABILITY COVERAGE: 10/30/5 or 100/300/50. The amount of liability coverage for property damage in these examples are $5,000 and $50,000 respectively.

Liability Insurance
XX / XX / XX
Maximum Per Person / Maximum Per Accident / Maximum Property Damage

Collision



The third part of automobile insurance covers collisions. It pays for damage to your car regardless of who is at fault. Collision insurance has deductibles ranging from $100 to $1,000. The company will never pay more than the value of your car, so IF YOUR CAR IS WORTH LESS THAN $1,000, DROP THIS COVERAGE.

If you don't have collision coverage and are in an accident that is not your fault, you must wait for the other person's insurance company to pay you for the damage. This process often takes months. You may need to hire a personal injury attorney to collect your damages. Without collision coverage, your insurance company has no responsibility to pay for repairs.

When you have collision coverage, your company will pay for the damage, then collect from the other driver's insurance company when the other driver is at fault. Also, if you pay a deductible to get your car repaired, your insurance company will return this amount to you when they get reimbursed.

Collision coverage pays for damage to your car

Comprehensive

COMPREHENSIVE IS THE THIRD TYPE OF AUTOMOBILE INSURANCE. IT COVERS OTHER DAMAGES TO YOUR CAR EXCEPT COLLISIONS WITH OTHER VEHICLES. SOME OF THESE INCLUDE GLASS BREAKAGE, THEFT, FIRE, VANDALISM, AND DAMAGE FROM HAIL OR STORMS.

Other Options

OTHER OPTIONS THAT CAN BE INCLUDED IN AN AUTOMOBILE POLICY ARE FOR MEDICAL PAYMENTS, UNINSURED MOTORISTS, AND NO-FAULT INSURANCE (PERSONAL INJURY PROTECTION). Most people don't need any of these. If you have health insurance, you are already covered for medical payments, so don't duplicate the coverage. The uninsured motorist coverage takes care of medical payments for you and your family members for hit and run accidents and for injuries caused by uninsured motorists. Since companies don't make duplicate payments, you don't need this protection when you have health insurance. A standard health policy insures all medical injuries from whatever source.

IF YOUR STATE HAS ADOPTED "NO-FAULT" LAWS, YOUR INSURANCE COMPANY WILL PAY UP TO A CERTAIN AMOUNT, GENERALLY $15,000, FOR YOUR PERSONAL INJURY PROTECTION (PIP) AND PROPERTY DAMAGE CLAIMS FROM AN ACCIDENT NO MATTER WHO IS AT FAULT. If your state has "no-fault" laws, you will pay an extra PIP premium for Personal Injury Protection.

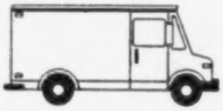
AUTOMOBILE INSURANCE INCLUDES:
✓ Bodily Injury Liability (Required)
✓ Collision
✓ Comprehensive

Premium Rates

Insurance companies decide the premiums they charge based upon:

✓ **TYPE OF CAR.** Luxury cars cost more to insure. The auto's crash resistance record also affects the premium rate. When shopping for a new car, get a quote from your insurance agent of the cost to insure the auto before you make the purchase.

✓ **USE OF CAR.** Whether the car is used mainly for business or mainly for pleasure affects the premiums. If you drive the car under 10,000 miles each year, you will pay a lesser premium.



✓ **DRIVING RECORD.** Good drivers with fewer tickets receive premium discounts for their good driving record.

- ✓ **DRIVER CLASSIFICATION.** Drivers are rated for premiums based on age, sex, and marital status. Those under 25 years of age pay higher premiums, because they have a higher accident ratio. Since males under 25 years of age have more accidents, they are rated higher than females of the same age. Singles pay more than couples for the same coverage.

- ✓ **RATING TERRITORY.** Those living in cities with higher population densities and more traffic pay more for their premiums than those who live in less populated rural areas.

Premium Discounts

MOST INSURANCE CARRIERS OFFER A REDUCED PREMIUM BASED ON DISCOUNTS. THESE PREMIUM DISCOUNTS WILL REDUCE YOUR OVERALL PREMIUM OUTLAY, SO BE SURE TO ASK ABOUT THEM. Also, inform your agent when you qualify for one or more of the standard discounts. The most common premium discounts include:

- ✓ **GOOD DRIVING RECORD**
- ✓ **DRIVER EDUCATION DISCOUNTS** and/or students under age 25 with **GOOD GRADES**
- ✓ **STUDENT** living 100 miles or more away from home listed as a driver on your policy
- ✓ **MULTIPLE CARS** insured with the same insurance carrier
- ✓ **SAFETY DEVICES** such as anti theft devices, auto belting, air bags, anti-lock brakes
- ✓ **NON-SMOKER** and/or **NON-DRINKER**
- ✓ **CAR POOL**

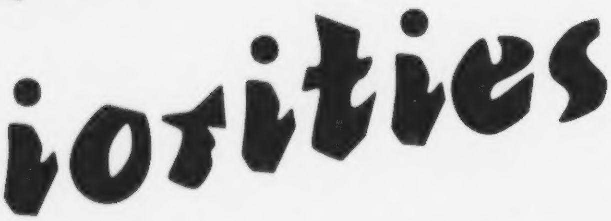
To save premium dollars and still maintain adequate coverage, keep your insurance agent well informed of all changes in your situation. Add your children under age 25 living at home as drivers on your policy. The cost is far less than them obtaining their own insurance. **NOTIFY YOUR AGENT IF YOU QUALIFY FOR ANY OF THE ABOVE DISCOUNTS, OR IF ANY OF YOUR COVERED CHILDREN GET MARRIED OR MOVE AWAY FROM HOME.**

For damage under $1,000, consider not filing a claim

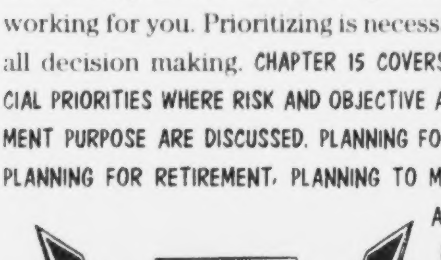
IF YOU HAVE DEDUCTIBLES OF $500 OR LARGER, YOU WILL PAY MUCH LESS FOR YOUR INSURANCE COVERAGE. ALSO, THE FEWER CLAIMS YOU FILE, THE BETTER YOUR RATING WITH THE INSURANCE COMPANY. Never file a claim for less than your deductible. For damage under $1,000, consider not filing a claim. The extra you pay up front to repair the car may save money in the long run. Most carriers will raise your rates when you file any claim, even when that claim is small.

PART V

Planning & Priorities



Making plans and setting priorities will point out the action you need to take to get more money working for you. Prioritizing is necessary for all decision making. CHAPTER 15 COVERS FINANCIAL PRIORITIES WHERE RISK AND OBJECTIVE AND INVESTMENT PURPOSE ARE DISCUSSED. PLANNING FOR SPECIFIC GOALS, PLANNING FOR RETIREMENT, PLANNING TO MAKE WISE INVESTMENTS, AND TAX PLANNING ARE THE TOPICS OF CHAPTER 16. CHAPTER 17 COVERS ESTATE PLANNING. CHAPTER 18 GIVES SOME IDEAS ON FINDING THE MONEY TO FUND YOUR GOALS.



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Chapter 15

Priorities

RISK AND OBJECTIVE

A FINANCIAL PYRAMID puts your savings and investment choices into categories. The broad base at the bottom of the pyramid is the foundation. The foundation includes insurance, savings plans, and home ownership. The other levels above the foundation are options you take to make your net worth grow. Each succeeding higher level shows choices that assume more risk. Levels three and four have options with low to moderate risk, while the choices on levels five through eight have moderate to high risks. A financial pyramid is shown in Table 15.1.

THE BASICS

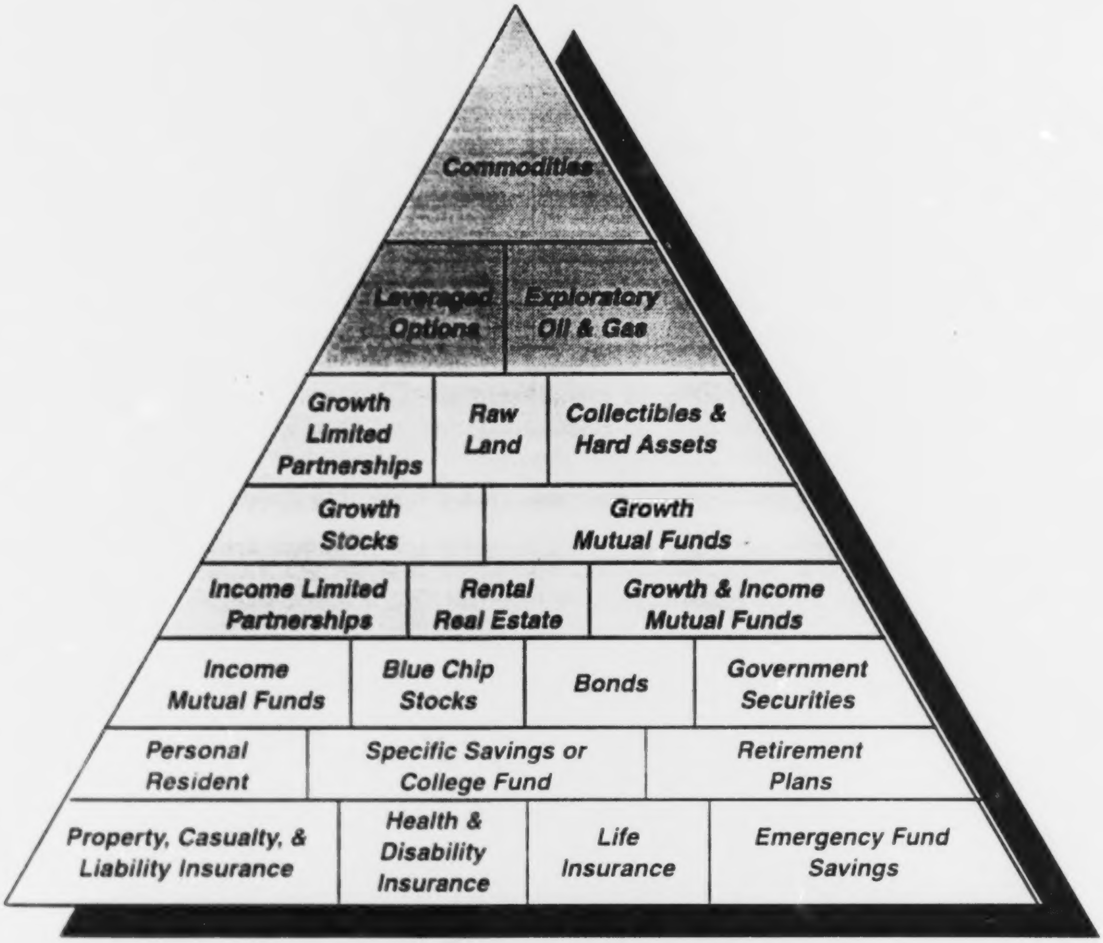
2
1
THE BASICS

A solid financial plan starts with the basics, those options shown on the first two levels of the pyramid, then progresses upward. **A STRONG FOUNDATION REDUCES EXPOSURE TO UNFORESEEN EVENTS AND UNPLANNED EXPENSES, THEREBY STRENGTHENING ONE'S ABILITY TO ACCUMULATE ASSETS. THE BASICS INCLUDE:**

- ✓ Sufficient **SAVINGS** to cover unanticipated emergencies
- ✓ Adequate **AUTOMOBILE AND HOMEOWNER'S INSURANCE**
- ✓ Sufficient **LIFE INSURANCE OR OTHER ASSETS** to provide for dependents should the provider die early
- ✓ Purchase of a **PERSONAL RESIDENCE**
- ✓ Funds to help **EDUCATE YOUR CHILDREN**
- ✓ Sufficient **INVESTMENTS AND SAVINGS TO COVER RETIREMENT** so those years are free from financial worry

IF THE PYRAMID IS 'TOP HEAVY' WITHOUT WIDESPREAD SUPPORT AT THE BASE, IT CAN TOPPLE. For example, those who invest in commodities, undeveloped land, or stock options when they have inadequate insurance coverage and no savings take unnecessary chances and could lose everything.

Table 15.1 FINANCIAL PYRAMID


Commodities
Leveraged Options
Exploratory Oil & Gas
Growth Limited Partnerships
Raw Land
Collectibles & Hard Assets
Growth Stocks
Growth Mutual Funds
Income Limited Partnerships
Rental Real Estate
Growth & Income Mutual Funds
Income Mutual Funds
Blue Chip Stocks
Bonds
Government Securities
Personal Resident
Specific Savings or College Fund
Retirement Plans
Property, Casualty, & Liability Insurance
Health & Disability Insurance
Life Insurance
Emergency Fund Savings

Property, Casualty, and Liability Insurance

Purchasing and maintaining a home and/or automobile(s) requires that you spend many hours working just to make the payments. These assets could be destroyed in an accident, fire,

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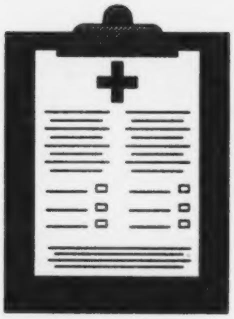
flood, or other hazard. **PROPER INSURANCE PREVENTS A MAJOR ACCIDENT OR DISASTER FROM BRINGING FINANCIAL RUIN BECAUSE THE INSURANCE COMPENSATES YOU FOR THE DAMAGES.** Unexpected lawsuits you may lose could also cause you to lose your assets. Liability protection via your homeowner's policy provides adequate protection for most commonplace incidents.

Health and Disability Insurance



A MAJOR ILLNESS SUFFERED BY YOU OR AN IMMEDIATE FAMILY MEMBER CAN BE EXTREMELY EXPENSIVE. Don't put yourself in the position of having to sell your assets to raise the money needed to care for yourself or a loved one. An extended illness without health insurance can deplete everything you own and still cost more money. Health insurance helps preserve your assets and provide the money to pay for major illnesses.

IN MOST CASES, GROUP HEALTH AND DISABILITY PLANS OFFERED THROUGH EMPLOYERS ARE THE LEAST EXPENSIVE. Many organizations offer group insurance to their members. When some type of group plan isn't possible, you will need to find an independent source.

THE CHANCES OF BECOMING DISABLED ARE MUCH GREATER THAN MOST PEOPLE REALIZE. Yet, **DISABILITY INCOME** is the most misunderstood of insurance policies. If you are a breadwinner and unable to work for an extended period, who pays the bills when your wages stop? Disability policies provide income during an extended illness not covered by sick pay.

Disability policies provide income during an extended illness not covered by sick pay

Life Insurance

LIFE INSURANCE PROTECTS THE EARNING POWER OF THE MAJOR WAGE EARNER(S) IN A FAMILY. Should income suddenly stop due to an unexpected death, life insurance provides the needed funds to care for dependents. Although adequate coverage is essential, don't overinsure. Your dollars can earn more in other places.

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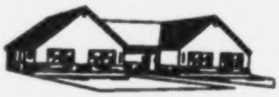
Emergency Fund Savings

EVERYONE NEEDS ENOUGH MONEY IN A LIQUID, "SAFE" SAVINGS ACCOUNT TO COVER UNEXPECTED EXPENSES. Then, if you must make a sudden trip to attend a funeral, your car breaks down, or your home needs a repair, you will have the money to pay for these items without relying on credit cards with their expensive finance charges.

DIFFERENT SITUATIONS CALL FOR VARIOUS AMOUNTS IN AN "EMERGENCY" ACCOUNT. A single person does not need as much savings as a family. A rule of thumb is to save an amount equal to three to six months living expenses. Then, if you ever lose your job or have emergency expenses, this fund will see you through. Incidentally, after dipping into your emergency fund, be sure to replenish it as soon as possible. And, if it grows beyond what you need, move the extra funds to a higher level on the pyramid where they will earn a better rate of return.

Personal Residence

OWNING YOUR OWN HOME IS A WIN/WIN SITUATION. It creates a tax savings that helps to free other money. Be aware that the location, the climate, and the job market of a particular area will affect the market value of your home. Homes can go down in value as well as up. Additionally, if you have a variable interest rate on your mortgage, the payment will fluctuate.



Specific Savings or College Fund

If you have a particular goal, it is important to set money aside to achieve it. Keep in mind that the sooner you start saving, the fewer dollars you will have to put away.

Retirement Plans

Contributions to most retirement plans are deducted from gross wages or gross income **BEFORE TAXES.** The deduction reduces taxable income dollar for dollar, providing tax relief. Included are: **IRAS, KEOGHS, SEP IRAS, 401(K)** plans, **ESOP** (employee stock option plans), **DEFERRED COMPENSATION, PROFIT SHARING,** and 403(b) plans for non-profit organizations. **RETIREMENT PLANS OFFER SEVERAL ADVANTAGES. THE EARNINGS ACCUMULATE FREE OF TAX, MAKING IT POSSIBLE TO SAVE MUCH MORE.**

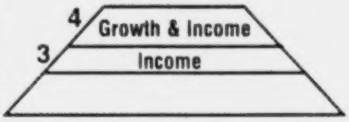
These plans become even more attractive if an employer matches a percentage of the employees contribution. An added feature for many 403(b) and 401(k) plans are the low interest loans. The loan option allows the contributor to feel comfortable saving larger amounts because he or she has access to the money without penalty through the loan provision. **A POLITICAL RISK** does exist with pension plans, however, because Congress frequently changes the tax laws. Additionally, these plans **ARE NOT LIQUID UNTIL AGE 59** without a 10% tax penalty.

A political risk does exist with pension plans because Congress frequently changes the tax laws

INCOME

GROWTH & INCOME

Once you cover the basics, use the investment choices shown on the mid-pyramid levels to fund your financial goals. The choices you select will depend on your **AGE**, your **OBJECTIVE**, your **RISK TOLERANCE**, and the **NUMBER OF YEARS** you expect to invest the money.



Bonds and Government Securities

MUNICIPAL BONDS, **CORPORATE BONDS**, and **GOVERNMENT SECURITIES** offer a **CONSISTENT INCOME**, but are subject to an **INTEREST RATE RISK**. They can provide higher rates of return than money market accounts, certificates of deposit, or bank savings accounts, but the principal will fluctuate. **WHEN GENERAL INTEREST RATES RISE OR FALL, THE BOND'S PRINCIPAL WILL DECREASE OR INCREASE IN VALUE.**

The principal of a bond fluctuates

Income Mutual Funds and Blue Chip Stocks

INCOME MUTUAL FUNDS and **BLUE CHIP STOCKS** (including many utility stocks) are subject to market risks, but offer fairly consistent dividends with some potential growth of principal. Income mutual funds may hold both stocks and bonds in their portfolio, or only stocks, or only bonds. They offer the same advantage as the underlying investment, but with better diversification.

Income mutual funds & blue chip stocks offer consistent dividends with potential growth of principal

Rental Real Estate

REAL ESTATE RENTALS OFFER DIRECT TAX ADVANTAGES FOR THOSE WHO MANAGE THEIR OWN PROPERTIES. The risk varies according to the type of property

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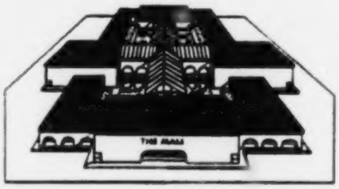
owned, the amount of rent received, and the payment due on the mortgage. Higher mortgages carry higher risks because when tenants move out the owner(s) must still cover the mortgage payment. Nevertheless, well-selected real estate offers equity buildup and tax write-offs.

Mutual Funds and Limited Partnerships



GROWTH AND INCOME MUTUAL FUNDS PROVIDE CONSISTENT DIVIDENDS WITH THE POTENTIAL OF AN INCREASING PRINCIPAL. They are subject to both an interest rate risk and a market risk. They often hold a mixed portfolio of stocks and bonds with an emphasis on quality blue chip stocks. **INCOME LIMITED PARTNERSHIPS** vary in value and risk because they can have investments in income producing oil wells, income producing real estate, or other income investments.

GROWTH

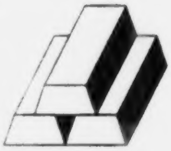
In general, growth investments pay little or no income, but can increase in value over the years. They assume more risk because their future value is unknown.

Growth Stocks and Growth Mutual Funds

IN THE PAST, WELL-SELECTED GROWTH STOCKS HAVE PROVEN TO BE AN EXCELLENT INFLATION HEDGE. SELECTION IS THE KEY. GROWTH MUTUAL FUNDS PROVIDE PROFESSIONAL MANAGEMENT AND, LIKE ALL MUTUAL FUNDS, OFFER DIVERSIFICATION. Many varieties of these funds exist, with some having the objective of aggressive growth. Growth mutual funds invest primarily in common growth stocks.

Growth Limited Partnerships, Hard Assets and Land

GROWTH LIMITED PARTNERSHIPS offer numerous investments. Some include investments in storage containers, movie rights, raw land, oil wells, or commercial real estate. A major risk of any limited partnership is the quality of management offered by the general partner. Also, fees and charges paid by the limited partners reduce potential profits.



COLLECTIBLES and **HARD ASSETS** include paintings, works of art, a sundry of valuable collections, gold, silver, and other precious metals. Since no open market exists for trading these investments, in order to sell, an owner must find a willing buyer. Often this means hiring a middleman to sell the asset, and the commissions charged by these dealers and brokers are quite expensive.

SPECULATIVE GROWTH

Speculative
Growth

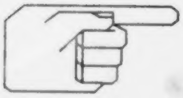
LEVERAGED OPTIONS, EXPLORATORY OIL AND GAS, and **COMMODITIES** trading are all high risk. They are for those who have covered their bases in the other areas and have extra dollars to "gamble." Much money can be made here, but these investments are very volatile and losses often occur.

INVESTMENT PURPOSE

ALONG WITH EVALUATING RISKS AND OBJECTIVES AS SHOWN ON THE FINANCIAL PYRAMID, YOU ALSO NEED TO IDENTIFY YOUR INVESTMENT PURPOSE. Investment purposes vary according to a person's age and income. Those who are young with time on their side will probably benefit the most from growth investments that offer a hedge against inflation. The middle-aged also need growth, but have less time, so should take a more conservative approach. Retirees, or those close to retirement, usually want a dependable income, so look to those "safe" accounts that generate consistent interest or dividends. Incidentally, even in retirement some growth is necessary to offset inflation.

Know what you want to achieve with your money. Is it for an emergency fund savings, for long-term savings, or do you need to live on some of the income? **PURPOSE LEADS YOU TO THE APPROPRIATE CHOICES.** Consider:

- ✓ **SAFETY**
- ✓ **LIQUIDITY**
- ✓ **INCOME**
- ✓ **TAX ADVANTAGES**
- ✓ **GROWTH (INFLATION HEDGE)**



SAFETY

A "SAFE" INVESTMENT MAY OR MAY NOT BE GUARANTEED. The federal government guarantees bank accounts up to $100,000 for members of banks covered by FDIC insurance. The federal government also pledges their credit to cover the different issues of U.S. Government Securities. Other investments are secured by the assets of the company or issuer. Such investments include annuities, life insurance contracts, and bonds. Mortgages are secured by a deed on the property.

THE QUALITY OF AN INSTITUTION'S ASSETS AND INVESTMENT PORTFOLIO ARE EXTREMELY IMPORTANT. THEY REFLECT THE OVERALL "SAFETY" OF THE MONEY YOU "LOANED" TO THE INSTITUTION. For example, if an insurance company owns large amounts of over-appraised real estate or junk bonds, those assets could lose value or become worthless, leaving investors with nothing backing their money.

LIQUIDITY

NORMALLY, ACCOUNTS THAT OFFER HIGH LIQUIDITY HAVE OTHER DISADVANTAGES SUCH AS LOWER YIELDS OR NO TAX ADVANTAGES. Bank **PASSBOOK ACCOUNTS** are easily converted to cash. This liquidity convenience, along with their safety, is the main appeal. All **CERTIFICATES OF DEPOSIT** are locked in for a number of months, so they have a penalty for early withdrawal. Although they are not as liquid as passbook accounts, they offer a higher yield. As a rule, **MONEY MARKET ACCOUNTS** offered through mutual funds pay the highest possible yields that maintain instant liquidity. These accounts are considered low risk; they are not "guaranteed" with FDIC insurance.

Other accounts also offer liquidity, but not with the same convenience. **INSURANCE POLICIES** with loan provisions have low interest loans, often at 5% or 6%. Most **ANNUITIES** offer a 10% (or more) free withdrawal each year without a contract penalty before the policy matures. In both insurance and annuity contracts, the owner will usually have a check within one to three weeks after submitting the paperwork. **MUTUAL FUNDS, STOCKS,** and **BONDS** can all be cashed in within five business days upon receipt of the proper form/certificate and signature guarantee. Most mutual funds allow shares to be sold through a telephone request. **THE MAIN DRAWBACK WHEN LIQUIDATING STOCKS, BONDS, AND MUTUAL FUNDS IS THAT THEY ARE SUBJECT TO MARKET OR INTEREST RATE RISKS. IF THE ACCOUNT VALUE IS DOWN WHEN YOU NEED YOUR MONEY, YOU LOSE. AS A RULE, THESE INVESTMENTS REQUIRE TIME TO BUILD THEIR VALUE.**

INCOME

BONDS pay a consistent income that can be taxable or tax free. The income remains the same for the life of the bond. If interest rates rise, the bond principal will lose value, but the interest payments remain constant. **CERTIFICATES OF DEPOSIT** and **MONEY MARKET FUNDS** also generate interest income that fluctuates with current interest rates. **BLUE CHIP STOCKS** and **UTILITY STOCKS** generally pay dependable dividends to their stockholders from corporate earnings and profits. **INCOME MUTUAL FUNDS** can offer steady payments by having in their portfolios in any/all of the above. They also have a history of steady payments. Finally, some **LIMITED PARTNERSHIPS** that invest in producing oil wells or unleveraged rental properties will pay an income stream to their limited partners from the rents and royalties received.

TAX ADVANTAGES

RETIREMENT PLANS offer a tax write-off for the contribution, plus tax free earnings on the principal. Since the tax is deferred during accumulation, all monies are fully taxed when withdrawn. Withdrawals must begin by age 70½ to avoid a 50% penalty. **MUNICIPAL BONDS** provide tax free income. In addition, all **U.S. GOVERNMENT SECURITIES** are free from state taxes. Many mutual funds invest only in municipal bonds or U.S. Government Securities, so offer the same tax free income with more diversification. Actively managed **RENTAL PROPERTIES** allow tax write-offs from depreciation and expenses that help offset the income. Numerous **LIMITED PARTNERSHIPS** offer investments that have tax credits to help those in higher income brackets. Limited partners have no say about the management of their investment or about the terms of sale.

GROWTH (INFLATION HEDGE)

GROWTH INVESTMENTS TYPICALLY GENERATE LITTLE OR NO INCOME, BUT CONCENTRATE ON INCREASING VALUE OVER TIME. Instead of paying dividends, these companies take their "earnings" and reinvest them back into the company to make it grow and become financially stronger. **COMMON GROWTH STOCKS** and **GROWTH MUTUAL FUNDS** (comprised of common growth stocks) are typical investments. Many investors have found that well-located **REAL ESTATE** purchased at the right price also offers appreciation. Investments that have strong appreciation are inflation hedges because their value increase will exceed the annual inflation rate.

SUMMARY

WHATEVER PURPOSE YOU SELECT FOR YOUR INVESTMENT DOLLARS, YOU CAN'T HAVE ALL BENEFITS IN ONE INVESTMENT. DIFFERENT PURPOSES REQUIRE DIFFERENT INVESTMENTS. FOR EXAMPLE, GROWTH INVESTMENTS THAT ARE GOOD INFLATION HEDGES PRODUCE LITTLE INCOME AND ARE NOT IMMEDIATELY LIQUID FOR A PROFIT. THEY NEED TIME TO MAKE THEM VALUABLE. FIXED INCOME ACCOUNTS THAT PAY STEADY INTEREST HAVE NO GROWTH OF PRINCIPAL AND THUS ARE POOR INFLATION HEDGES. INVESTMENTS THAT OFFER TAX ADVANTAGES OFTEN LACK LIQUIDITY. SAVINGS THAT PROVIDE SAFETY AND LIQUIDITY ARE POOR INFLATION HEDGES.

> **Know what you value,
> and take the time
> to implement those values**

EVERYTHING IS A TRADE-OFF, SO ABOVE ALL, KNOW WHAT YOU GIVE UP, AND KNOW WHAT YOU WANT TO ACHIEVE WITH YOUR INVESTMENT DOLLARS. Financial priorities take thought and time—thought to know what you value, and time to implement those values.

Chapter 16

Planning

SAVING FOR SPECIFIC GOALS

A specific savings goal might be a child's education, a down payment for a home, a vacation, or an assessment coming due. **ESTIMATING HOW MUCH YOU NEED TO SAVE TO HAVE XXX DOLLARS LATER REQUIRES KNOWING THE RATE OF RETURN THE "SAVED" MONEY WILL RECEIVE FOR THE TIME IT IS SAVED.** Tables 16.1 and 16.2 show how much you need to put away now to have a certain future sum. To allow for a wide range of savings and investment options, the periods range from five to twenty years, and the compound earnings range from 3% to 12%.

✓ Table 16.1 shows the LUMP SUM (one time investment) needed to equal $1,000.

✓ Table 16.2 shows the ANNUAL INVESTMENT needed to equal $1,000.

Follow instructions at the bottom of each table to figure amounts other than $1,000. **KNOWING THE DOLLARS YOU NEED CAN MAKE A GOAL REALITY, ESPECIALLY WHEN THE AMOUNT NEEDED IS LESS THAN YOU THOUGHT.**

Table 16.1 LUMP SUM NEEDED TO EQUAL $1,000

Years	5%	6%	7%	8%	9%	10%	11%	12%
20	377	312	258	215	178	149	124	104
19	377	331	270	232	194	164	138	116
18	416	350	296	250	212	180	153	130
17	436	371	317	270	231	198	170	146
16	458	394	339	292	252	218	188	163
15	481	417	362	315	275	239	209	183
14	505	442	388	340	299	263	232	205
13	530	469	415	368	326	290	258	229
12	557	497	494	397	356	319	286	257
11	585	527	475	429	388	350	317	287
10	614	558	508	463	422	386	352	322
5	784	747	713	681	650	621	593	567

For larger amounts such as:
$ 5,000 → multiply table amount by 5
$ 7,300 → multiply table amount by 7.3
$25,000 → multiply table amount by 25

Table 16.2 ANNUAL INVESTMENT NEEDED TO EQUAL $1,000

Years	5%	6%	7%	8%	9%	10%	11%	12%
19-20	33	30	27	24	22	20	18	16
17-18	39	35	32	30	27	25	22	20
15-16	46	43	40	37	34	31	29	27
13-14	56	53	50	47	44	41	38	36
11-12	70	67	63	60	57	54	51	48
9-10	91	87	83	80	77	74	71	68
8	105	101	97	94	91	87	84	81
7	123	119	116	112	109	105	102	99
6	147	143	140	136	133	130	126	123

For larger amounts such as:
$ 5,000 → multiply table amount by 5
$ 7,300 → multiply table amount by 7.3
$25,000 → multiply table amount by 25

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INVESTMENTS FOR SPECIFIC GOALS

WALL STREET

Ten Years or Longer

With time on your side, you can consider growth investments. If you have ten years or longer to achieve your financial goal(s), select your investment considering how comfortable you are with varying degrees of risk.

FOR MANY WHO ARE NOT USED TO INVESTING AND WANT TO MINIMIZE RISK, A MUTUAL FUND WITH A CONSISTENT, WELL-ESTABLISHED, LONG-TERM TRACK RECORD IS A SAFE CHOICE. Several available growth and income funds and balanced funds have averaged an approximate 12% compound rate of return for money invested with the fund ten years or longer. The portfolios of these funds have a mixture of quality stocks and bonds that maintain value under changing market conditions. They are often not the year's "hottest" funds, but funds with a proven history of performance. They grow in "up" markets, and hold their value in "down" markets.

ZERO COUPON BONDS

Another investment choice is **ZERO COUPON BONDS**. A zero coupon bond is bought at a discount, then the interest accumulates until the bond matures. **YOU CAN PLAN THE MATURITY DATE FOR THE TIME WHEN YOU WILL NEED THE MONEY.** These bonds can be used to accumulate a specific amount of money. A disadvantage is the bond's sensitivity to interest rates, especially for longer maturities. For example, a $1,000 bond with twenty years to maturity will drop in value from $372 to $307 when interest rates rise from 5% to 6%. If you hold the bond until it matures, you will always get its full value. An advantage is the lower out-of-pocket cost at purchase. A $1,000 bond earning 6% with ten years to maturity costs $554. **TABLE 16.3 SHOWS WHAT YOU WOULD PAY FOR A ZERO COUPON BOND FOR VARIOUS MATURITY DATES AND YIELDS.**

Table 16.3 VALUE PER $1,000, ZERO COUPON BOND

Years To Maturity	Yield To Maturity on $1,000 Bond			
	5%	6%	7%	8%
20	$372	$307	$253	$208
18	411	345	290	244
16	454	388	333	285
14	501	437	382	333
12	553	492	438	390
10	610	554	503	456
8	674	623	577	534
6	744	701	662	625
4	821	789	759	731
2	906	888	871	855

You buy U.S. Government **SERIES EE BONDS** at a discount. At maturity the redemption value is double the issue price. The interest rate paid determines how many years until the bond matures. If you cash in the bonds early, you will receive a reduced interest rate. You can pay income taxes on the interest earnings when you cash in the bond, or you can elect to pay the tax annually. **IF PURCHASED AFTER 1990, SERIES EE BONDS ARE TAX FREE WHEN USED TO PAY FOR EDUCATION.** Many trade and technical schools qualify along with colleges and universities for this tax free advantage. To receive the full tax free status, the following conditions apply:

- ✓ The bond purchaser must be 24 years of age or older.
- ✓ The bonds used for a child's education must be in the parent's name(s) and redeemed by the parents
- ✓ The bond proceeds must be used for tuition and fees for dependents, spouse, or bond-owner. (Room and board and books do not qualify.)
- ✓ The year's educational expenses must exceed or equal the value of the bond. If the bond is worth more, the "tax free" interest is pro-rated.
- ✓ For married couples filing jointly, their taxable income must be under $62,900. For singles and head of household filers, their taxable income must be under $41,950.

Table 16.4 SERIES EE BONDS

Issue Price	Face Amount
$ 25.00	$ 50.00
$ 37.50	$ 75.00
$ 50.00	$ 100.00
$ 100.00	$ 200.00
$ 250.00	$ 500.00
$ 500.00	$ 1,000.00
$ 2,500.00	$ 5,000.00
$ 5,000.00	$ 10,000.00

Under Ten Years

SAVINGS
ACCOUNT

WITH ONLY FIVE TO TEN YEARS TO INVEST, IT IS WISE TO TAKE LESS RISK WITH YOUR INVESTMENTS. Select returns you can count on. This could be stock from well-established corporations that show a history of profits, short-term corporate bonds, short-term Government Securities, or fixed interest accounts. Due to the shorter time period, your investment is subject to a loss through interest rate risk, market risk, and even political risk. If you have to liquidate when the value is down, you will lose some money.

RETIREMENT

TRAVEL FOLDERS
TICKETS
BAG TAG
STC

While earning money, you need to adequately plan for the time your paychecks will stop. If you don't, frustration or even hardship could result. This is especially true since life expectancies keep rising and the cost of living keeps increasing every year. Being prepared for living longer and being prepared for higher prices requires extra money. **WHAT YOU ARE ABLE TO SAVE AND INVEST DURING YOUR WORKING YEARS DECIDES IF YOUR RETIREMENT WILL BE A TIME OF TRAVEL AND LEISURE, OR A TIME OF SCRIMPING AND CONFINEMENT.**

$$$ THE DIFFERENCE BETWEEN AN OLD MAN AND A GENTLEMAN IS INCOME $$$

Table 16.5 shows how many years actuaries expect the average person to live after retiring.

Table 16.5 UNISEX LIFE EXPECTANCY TABLE

AGE	Life Expectancy
55	23 More Years
60	20 More Years
65	16 More Years
70	13 More Years

Future Dollars Needed

THOSE RETIRING AT AGE 55 NEED ADEQUATE INCOME FOR TWENTY-THREE YEARS OR LONGER. Will your future pension benefits, social security, and your personal savings and retirement plans be adequate to cover your future expenses? To answer, you need to know:

A An estimate of monthly income (in today's dollars) that you will need when you retire $______

B The number of years from today until you plan to retire ______

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Next, you need to convert today's dollars to the dollars needed for your future. Every year the dollar loses value because of inflation, and that loss must be considered for future projections in order to maintain the same buying power. Average inflation rates in the past have been:

- 10 Years = 3.66%
- 15 Years = 4.94%
- 20 Years = 5.73%

YOU NEED TO ESTIMATE WHAT YOU THINK THE INFLATION RATE WILL BE FOR THE NUMBER OF YEARS UNTIL YOU RETIRE. Don't use less than the averages. Then multiply the estimate of monthly income needed in today's dollars (Part A) by the inflation factor from Table 16.6 for the number of years until you retire (Part B).

C The monthly income you will need converted to future dollars $ __________
"A" times Inflation Factor for "B"
(See Table 16.6)

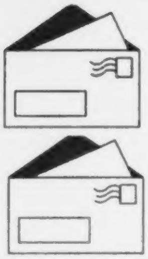
Example:

Lloyd, age forty, decides he needs $1,500 per month in today's dollars to live on when he retires. He plans to retire in twenty years at age sixty. He expects inflation to be 6% during that time period. So, he multiplies $1,500 by 3.207, the factor found under 6% and across from twenty years. 3.207 x $1,500 reveals that in twenty years Lloyd will need $4,811 per month in future dollars to equal today's $1,500.

Table 16.6 INFLATION IMPACT TABLE

Years	3%	4%	5%	6%
5	1.159	1.217	1.276	1.338
6	1.194	1.265	1.340	1.419
7	1.230	1.316	1.407	1.504
8	1.267	1.369	1.477	1.594
9	1.305	1.423	1.551	1.689
10	1.344	1.480	1.629	1.791
11	1.384	1.539	1.710	1.898
12	1.426	1.601	1.796	2.012
13	1.469	1.665	1.886	2.133
14	1.513	1.732	1.980	2.261
15	1.558	1.801	2.079	2.397
16	1.605	1.873	2.183	2.540
17	1.653	1.948	2.292	2.693
18	1.702	2.026	2.407	2.854
19	1.754	2.107	2.527	3.026
20	1.806	2.191	2.653	3.207
25	2.094	2.666	3.386	4.292
30	2.427	3.243	4.322	5.743

What Will You Receive?



THE NEXT STEP CALCULATES WHAT YOU EXPECT TO RECEIVE FROM ALL YOUR RETIREMENT BENEFITS. This includes your employer's pension plan, your social security benefits, and your private retirement funds such as IRA's, 401(k)s, etc., plus cash value life insurance, and/or other savings and investments.

D

Monthly income expected from company pension plans $__________

Monthly income expected from social security (See Appendix, *Social Security Retirement Benefits*) $__________

Monthly income expected from all other sources $__________

Total monthly benefits expected **$**__________

Next, compare your expected benefits to the future dollars you will need. If you are short, start planning now for ways to supplement your retirement income.

E

Monthly income you will need (From Part "C") $__________

Monthly benefits expected (From Part "D") $__________

Dollars Short (Monthly) **$**__________

WHAT YOU NEED TO SAVE

THE FOLLOWING WILL HELP YOU CALCULATE WHAT YOU NOW NEED TO BEGIN SAVING IN ORDER TO MAINTAIN YOUR CURRENT LIFESTYLE IN RETIREMENT. Take your monthly dollars short from Section "E" and multiply it by 12 to get the annual dollars short.

F

Annual Dollars Short $__________

How many years you are expected to live after retiring (See Table 16.5) __________

Total amount needed to cover your retirement (Line 1 x Line 2) $__________

Part "F" gives the total dollars short for the number of years you can expect to be retired, based on unisex life expectancy tables.

Example:

Sandy plans to retire in five years at age 55 and is now projected to be $200 short per month at retirement, or $2,400 annually. At age 55 her life expectancy is 23 years (Table 16.5). $2,400 (annual amount short) x 23 (life expectancy at retirement age) equals $53,200. Sandy needs to save $53,200 during the next five years to have a secure retirement and not change her lifestyle. Once Sandy does retire, her money needs to earn a break-even rate of return each year for her to maintain current purchasing power. (Break-even rate of return is discussed later in this chapter.)

Sandy's advance planning is not good news for her. She may have to work two or three years longer than she anticipated just to save the extra money she will need. She is glad, however, that she discovered the amount short now rather than after she retires. At least now she can do something about it.

How Much Do You Need to Save?

THE FINAL STEP SHOWS WHAT YOU NEED TO START SAVING TO MAKE UP THE PROJECTED DOLLARS SHORT. Tables 16.7 and 16.8 help you calculate what you need to save. These tables give a monthly or lump sum investment needed for the number of years to retirement. Use the total amount needed to cover your retirement from Part "F". The information at the bottom of each table tells how to covert the $100,000 table amount into larger or smaller sums.

Example Continued:

Sandy is short $53,200. The factor she would use from Table 16.7 is .532 (53,200 ÷ 100,000 = .532). Assuming she expects to earn 6% on her money, she needs to start saving $766 each month to have the required sum in five years ($1,439 x .532 = $765.55 — see Table 16.7 for 5 years @ 6%).

Had she looked at her situation five years earlier, with ten years to retirement the amount she needed to save would have been only $374 per month. With more time for the money to work, she also could have increased her rate of return, thereby reducing the needed monthly savings even more.

Table 16.7 MONTHLY INVESTMENT REQUIRED TO HAVE $100,000

	5 Years	10 Years	15 Years	20 Years	25 Years	30 Years
3%	1,547	716	441	305	224	172
4%	1,508	679	406	273	195	144
5%	1,475	648	378	246	171	120
6%	1,439	615	349	221	148	100
7%	1,405	585	321	197	128	82
8%	1,371	555	296	176	110	67
9%	1,338	527	273	157	95	55
10%	1,306	500	251	139	81	44
11%	1,275	475	231	124	69	36
12%	1,245	451	212	110	59	29

Divide the total dollars short by $100,000. This factor times the appropriate table amount will give you the sum you need to save monthly to reach your retirement goal.

Examples:
Dollars short = $52,000; $52,000 ÷ 100,000 = **.52.** With 10 years to retirement and expected earnings of 6%, save $320 monthly (615 x .52 = 319.80).

Dollars short = $225,000; $225,000 ÷ 100,000 = **2.25.** With 20 years to retirement and expected earnings of 11%, save $279 monthly (124 x 2.25 = 279).

All rates of return are compound annual rates

Table 16.8 LUMP SUM INVESTMENT REQUIRED TO HAVE $100,000

	5 Years	10 Years	15 Years	20 Years	25 Years	30 Years
3%	86,261	74,409	64,186	55,368	47,761	41,199
4%	82,193	67,556	55,526	45,639	37,512	30,832
5%	78,353	61,391	48,102	37,689	29,530	23,138
6%	74,726	55,839	41,727	31,180	23,300	17,411
7%	71,299	50,835	36,245	25,845	18,425	13,137
8%	68,058	46,319	31,524	21,454	14,602	9,938
9%	64,993	42,241	27,454	17,843	11,597	7,537
10%	62,092	38,554	23,939	14,864	9,230	5,731
11%	59,345	35,218	20,900	12,403	7,361	4,368
12%	56,743	32,197	18,270	10,367	5,882	3,338

Divide the total dollars short by $100,000. Use this factor to multiply the amounts in the table. This will give you the correct sum that you need to save monthly to reach your retirement goal.

Dollars short = $52,000; $52,000 ÷ 100,000 = .52. With 10 years to retirement and expected earnings of 6%, you would need to save $29,036. ($55,839 x .52 = $29,036)

Dollars short = $225,000; $225,000 ÷ 100,000 = 2.25. With 20 years to retirement and expected earnings of 11%, you would need to save $27,907 now to have $225,000 in 20 years **($12,403 x 2.25 = $27,907).**

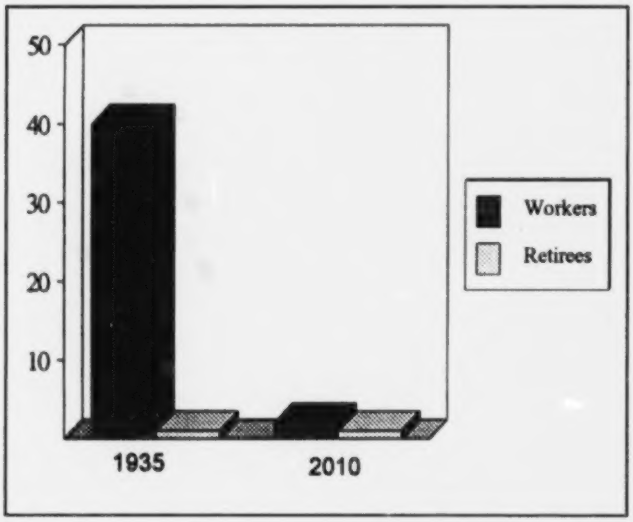
All rates of return are compound annual rates

Social Security

SOCIAL SECURITY ALONE WILL NOT BE ADEQUATE INCOME FOR FUTURE RETIREES. The system was always designed to be supplemental, and it truly will be just "a supplement" in the future. As the baby boomers (those born between 1946 and 1964) reach retirement age and begin to "take" from the system, retirees will dramatically outnumber contributing workers.

IN 1935 WHEN SOCIAL SECURITY ORIGINATED, EACH RETIREE HAD FORTY WORKERS PAYING EMPLOYMENT TAXES. BY THE YEAR 2010 WHEN THE FIRST OF THE BABY BOOMERS REACH AGE 65, ONLY TWO WORKERS WILL BE PAYING TAXES FOR EACH RETIREE. Given these facts, and the staggering FICA tax increases already imposed upon current workers, benefits are likely to decrease.

Table 16.9 SOCIAL SECURITY WORKERS & RETIREES



PLANNING TOOLS

Tax Bracket

**To make wise investment decisions,
you need to know
your income tax bracket**

TO MAKE WISE INVESTMENT DECISIONS, YOU NEED TO KNOW YOUR INCOME TAX BRACKET. Consider your tax bracket when looking at investments expected to generate tax write-offs or add to taxable income. Currently, all income is taxed by the federal government at 15% until it reaches a certain level. Then it moves to the higher brackets: 28%, 31%, 36% & 39.6%. Each year the dollar amount of these brackets change (see the Appendix for the 1995 federal rates). To the federal taxes, you then add the percentage from your state. To get this percentage, see the Appendix: *State Tax Rates*.

(FEDERAL %) + (STATE %) = TAX BRACKET

IF YOU MULTIPLY YOUR TAX BRACKET BY ANY ADDITIONAL INCOME (INTEREST, DIVIDENDS, BONUSES, CAPITAL GAINS, ETC.), YOU WILL KNOW THE PERCENTAGE YOU WILL PAY IN TAXES, AND CORRESPONDINGLY THE PERCENTAGE YOU GET TO KEEP.

Example:

If you are in a 35% tax bracket (28% federal plus 7% state), while you remain in this bracket, 35% of any additional income goes to taxes, and you keep 65%. That means when you earn $2,000 in taxable interest, $700 goes directly to tax ($2,000 x 35% = $700), leaving you with a $1,300 profit. A raise at work of $100 leaves you with $65 after the 35% is taken out for taxes.

**A deductible expense
times your tax bracket
shows your tax savings**

ON THE OTHER HAND, DEDUCTIBLE EXPENSES HAVE A LOWER 'REAL' COST DUE TO THE TAX SAVINGS. Expenses such as qualified pension plan contributions, alimony, mortgage interest, charitable contributions, etc., actually cost less than their dollar value because they also reduce your taxes. A deductible expense times your tax bracket shows an estimate of your tax savings.

Example:

For the same 35% tax bracket, a contribution of $5,000 to a SEP IRA has an out-of-pocket cost of $3,250. The balance, or $1,750, comes from tax savings ($5,000 x 35% = $1,750). You reduce your taxes by $1,750 due to the $5,000 contribution.

If your mortgage interest is $900 a month, or $10,800 a year, and your tax bracket is 35% (28% federal + 7% state), you will have a $3,780 tax reduction due to the mortgage interest paid ($10,800 x 35% = $3,780). Considering the $3,780 in taxes saved, the net cost of the mortgage is $7,020.

Break-Even Rate of Return

TO GET AHEAD YOU MUST EARN MORE THAN THE AMOUNT LOST THROUGH INFLATION AND TAXES. The following shows the net return on $100. The conditions are:

- 5% interest earnings
- 4% inflation
- A 35% tax bracket (28% federal + 7% state)

Example:

If $100 earns 5% interest, at the end of the year it is worth $105. The $5.00 in earnings is fully taxed. In a 35% tax bracket you will pay $1.75 in taxes, which leaves net earnings of $3.25 or a total of $103.25. The 4% inflation rate then reduces the purchasing power of $103.25 to $99.12. In other words, the $100 that grew by $5.00 in one year is worth $99 at year's end after inflation and taxes take their bite.

YOUR DOLLARS SHRINK EVERY YEAR THAT THEY DON'T BREAK EVEN. A formula used to figure a **BREAK-EVEN RATE OF RETURN**, or the minimum you must earn to keep up with taxes and inflation, is:

$$\frac{\text{Inflation Rate}}{\text{(100) minus (Tax Bracket)}} = \text{Break-Even Rate of Return}$$

If the inflation rate is 4%, and your tax bracket is 35%, you need to earn 6.15% just to break even! With the same 35% tax bracket, if the inflation rate rises to 6%, your break-even point becomes 9.2%.

$$\frac{4\%}{100\% - (35\%)} = 6.15\%$$

A STANDARD RULE OF THUMB USED BY MANY INVESTORS IS: YOU NEED TO RECEIVE A NET 2% RETURN AFTER INFLATION AND TAXES. THAT MEANS 2% ABOVE YOUR BREAK-EVEN RATE OF RETURN.

ANNUAL TAX PROJECTION

Estimating your annual taxes can help you have the correct amount withheld or paid in through estimated payments. When an event changes your finances, you will know what you can expect to pay in taxes. Such advance planning leads to better management of your money. It could mean higher monthly take home pay and/or no surprises at tax time. Some circumstances that will change your taxes are:

PERSONAL CHANGES

- ✓ change in marital status
- ✓ losing a dependent
- ✓ gaining a dependent

INCOME

- ✓ increase in salary
- ✓ decrease in salary
- ✓ unexpected income
- ✓ increase in interest
- ✓ increase in dividends
- ✓ large state tax refund
- ✓ receiving alimony
- ✓ bonus
- ✓ gambling winnings
- ✓ gain from sale of investment
- ✓ gain from sale of home (if tax able)
- ✓ increased business profits
- ✓ taxable fringe benefits
- ✓ increased rental income

EXPENSES

- ✓ buying a home
- ✓ a business "loss"
- ✓ paying alimony
- ✓ change in state taxes paid
- ✓ increase in tax deferred retirement contributions
- ✓ medical expenses exceeding 7.5% of AGI
- ✓ business expense exceeding 2% of AGI
- ✓ qualified child care expenses
- ✓ out-of-pocket moving expenses
- ✓ paying alimony

Use the **ANNUAL TAX PROJECTION FORM** to estimate what you will owe any time one or more of the above events change your financial situation. You will need to refer to the current year's tax rates, or estimate by using last year's tax bracket. An estimate using last year's rates will be close enough if the current year is not subject to major tax reform. Use annual figures for all entries.

Table 16.10 ANNUAL TAX PROJECTION WORKSHEET (Federal)

GROSS INCOME

Gross Annual Salary ____________

Gross Annual Salary ____________

Other ____________

Other ____________

Total Income = A **A** $____________

DEDUCTIONS FROM INCOME

Deductions, standard or itemized: B-1 **B-1** (____________)

Adjustments to income: B-2 **B-2** (____________)

Exemption Credits: Dependents claimed _____

(Standard exemption x dependents claimed) (____________)

_____ x _____ = _______ (____________)

Total Deductions = B **B** $ (____________)

Taxable Income: A minus B = C **C** $____________

Tax due on line C (*see tax rate schedules*) ____________

Other taxes (*Self-employment and other taxes*) ____________

Total Taxes Due = D **D** $____________

Federal taxes withheld from salary(ies) ____________

Estimated tax payments ____________

Other payments or credits ____________

Total Payments = E **E** $ (____________)

Balance Due or Refund: D minus E = F **F** $____________

B-1

Itemized Deductions or Standard Deduction

Medical expenses exceeding 7.5% of AGI $ ____________

State income taxes paid (withheld + additional paid) $ ____________

Real estate taxes paid $ ____________

Personal property tax (automobiles, etc.) $ ____________

Home mortgage interest and points $ ____________

Charitable contributions $ ____________

Business expenses exceeding 2% of AGI $ ____________

Deductible casualty or theft losses $

Total Itemized Deductions = Total 1

Standard Deduction (from tax tables) = Total 2

Total 1	**$**
Total 2	**$**

(Take the higher of Total 1 or Total 2 to Line B-1)

B-2

Alimony paid $ ____________

Deductible contributions to retirement plans $ ____________

Other adjustments to income $ ____________

Total Adjustments (take to Line B-2) $____________

The amount of tax you will owe will be the tax due on line C minus any credits such as child care credits. Refer to Chapter 7, *Personal Income Taxes* for more information about credits, deductions, and taxable income.

SUMMARY

TAX AND INVESTMENT PLANNING STOPS SURPRISES AND HELPS YOU TAKE CONTROL OF YOUR FINANCES. ALSO, IN MANY CASES, KNOWING WHAT YOU NEED TO SAVE TO REACH A FUTURE GOAL BECOMES THE IMPETUS TO START SAVING. As long as future needs remain "vague" and "out there," they will give you cause to worry. Recognizing and dealing with the facts: about how much money you need, what it will take to get that money, and what you will owe in taxes gives you a "track to run on."

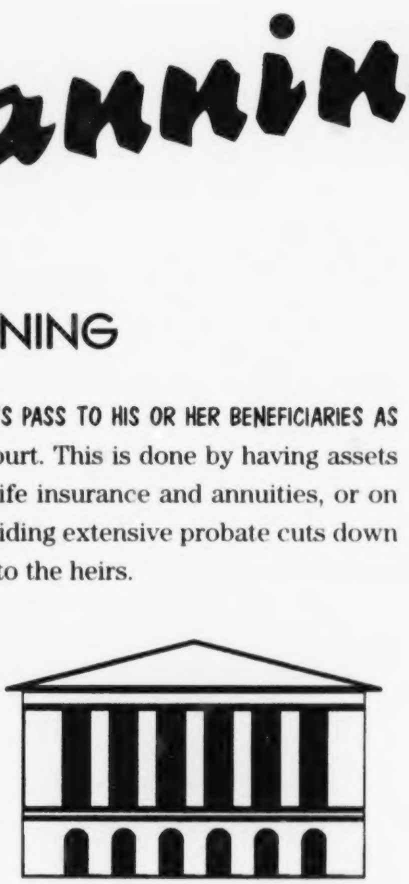
Whether you plan for a child's education, a trip, a down payment, or your retirement, **KNOWING WHAT YOU NEED HELPS YOU TO MAKE DECISIONS.** Priorities and planning go hand in hand. Neither are easy, but both are necessary to be in charge of your finances.

Chapter 17

Estate Planning

INTRODUCTION TO ESTATE PLANNING

A GOOD ESTATE PLAN ASSURES THAT A DECEASED PERSON'S ASSETS PASS TO HIS OR HER BENEFICIARIES AS INTENDED. It also helps to keep property out of the probate court. This is done by having assets pass to heirs directly as named beneficiaries on trusts, on life insurance and annuities, or on property held in joint tenancy with right of survivorship. Avoiding extensive probate cuts down on delays and reduces fees and taxes, thereby leaving more to the heirs.



PROBATE IS A LEGAL PROCESS SUPERVISED BY THE PROBATE DIVISION OF THE STATE COURT. It passes ownership of property from a deceased person to others. **THE PROBATE COURT ALSO APPROVES WILLS, VALUES ASSETS, PAYS OFF CREDITORS, FILES ESTATE TAXES, DIRECTS AN ESTATE TRUSTEE, AND OVERSEES THE ADMINISTRATION OF PROPERTY LEFT TO MINOR CHILDREN.** The probate court follows the instructions in a will whenever it can under the law. Without a will, state law directs the distribution of property and appoints guardians for minor children.

THE FIRST STEP IN ESTATE PLANNING IS TO KNOW THE VALUE OF ALL YOUR ASSETS. If the value is under $600,000, a will and property set up to pass directly to heirs is probably sufficient. Currently, estates valued under $600,000 are not subject to federal estate tax.

Gifting

IF YOUR ESTATE IS OVER $600,000, "GIFTING" HELPS TO REDUCE THE TAXABLE ESTATE. THIS MEANS GIVING PROPERTY OR MONEY EARLY TO POTENTIAL HEIRS. Each person can gift up to $10,000 each year ($20,000 per couple) with no gift tax due. The beneficiary will only pay tax on the earnings from their "gift." The amount given is not taxable. Gifting transfers assets to family members and removes these assets from the taxable estate.

Taking Title

THE WAY TITLE IS HELD ON JOINTLY-OWNED PROPERTY (TWO OR MORE PERSONS) AFFECTS HOW THE PROPERTY IS HANDLED WHEN ONE PARTY DIES.

- **JOINT TENANCY WITH RIGHT OF SURVIVORSHIP:** This form of title denotes equal ownership and can be held by two or more persons, who are often referred to as tenants. If three people own the property, each has a one-third undivided interest. If two own the property, each has a one-half undivided interest. When one tenant dies, the property passes automatically to the other tenant(s) outside the will, thus avoiding probate.

- **TENANTS IN COMMON:** This form of title allows for unequal ownership and unequal distributions. One person may own 70% and the second person 30%. No right of survivorship exists. A deceased tenant's ownership rights would pass under his or her will.

- **COMMUNITY PROPERTY:** Currently nine states are community property states; the remaining states are called "common-law" states. Under community property rules, all property acquired during a marriage, except gifts, inheritances, and income derived from these, belong equally to both spouses regardless of who purchased or earned the property. Furthermore, how the property is titled is irrelevant. In cases of divorce and death, the spouses share 50/50 in all assets accumulated during their marriage. In common-law states, property from divorce and death pass to beneficiaries and heirs as titled, or through a will. (See the Appendix: *Community Property States*)

Wills

Joint ownership with right of survivorship by itself cannot be regarded as an "estate plan." A will defines many additional ways property can be divided and allows for more options. Equally important, a will appoints guardians for younger children, and an administrator for the estate.

A WILL

- **Offers many options for dividing property**
- **Appoints guardians for minor children**
- **Appoints an administrator for the estate**

FOR THOSE WHO DIE WITHOUT WILLS, THE STATE DECIDES WHO RECEIVES THEIR PROPERTY, WHO BECOMES GUARDIAN(S) FOR THEIR MINOR CHILDREN, AND WHO ADMINISTERS THEIR ESTATE. Under certain circumstances, the state can even take the property. Understandably, any additional administration adds to probate costs, reducing the final amount received by heirs.

For couples with minor children, a will is a must. Joint ownership with right of survivorship does not settle the matter of guardianship for the children should both parents die on or about the same time. Neither does joint ownership appoint a person to dispose of the estate assets and file the final tax return. A will, however, can provide these tools.

For couples with minor children, a will is a must

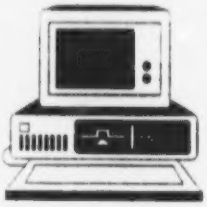
WILLS REQUIRE LEGAL LANGUAGE DRAFTED BY ATTORNEYS WHO ARE FAMILIAR WITH APPLICABLE STATE AND FEDERAL LAWS. Small technicalities, unknown to laypersons, can make a will invalid. Individuals often make the mistake of writing in dollar amounts, which can quickly become outdated, or the estate may not have enough money to pass on the intended sum. Percentages work much better because they require fewer changes.

ESTATE PLANNING

Another common error people make when they write their own will is asking a beneficiary to be a witness. This action can void all gifts left to that beneficiary. People also make a mistake when they write over or cross out an item in the will. This can make the will invalid. Generally, wills should be formally amended. **A CODICIL IS AN AMENDMENT TO A WILL** that can be used instead of redrafting the entire document. It can add new provisions and change or delete existing ones.

Furthermore, wills have little use if they are not kept current. As family and financial situations change, wills should be updated. Changes in federal and state laws, as well as births, deaths, marriages, and divorces within one's family can make a will's provisions obsolete.

To be effective, wills must be kept current



If you have a computer, you can purchase software (designed by attorneys) for an approximate cost of $60 to draw up your own will. Most software considers the particular laws of each state and comes with a complete instruction manual. Although the software doesn't save much over the initial attorney fees to draft a will, it has the advantage of allowing you to do your own updates and changes with ease.

PROBATE

PROBATE LAW

HAVING A WILL DOES NOT AVOID PROBATE. The will merely gives instructions to the probate court on how the deceased wishes to have his or her estate handled. Without a will, all property is distributed according to state laws.

PROBATE IS EXPENSIVE AND TIME CONSUMING. Avoiding probate is not illegal, but wise estate planning. **TO AVOID PROBATE, DO NOT LEAVE PROPERTY TO MINOR CHILDREN WITHOUT CREATING A TRUST FOR THEIR BENEFIT OR APPOINTING A PERSON AS THEIR GUARDIAN.** For example, if life insurance proceeds are left directly to minor children with no provision for a guardian or trustee, then the court must decide who will manage those funds for the benefit of the children. The court usually appoints a bank that will charge an annual administrative fee. Without a will, the court also decides who will take care of the children. Although unlikely, it could be someone unknown to the deceased's family.

Avoiding probate is wise estate planning

Granting the executor of an estate the power to settle will disputes and sell estate property if needed can help to reduce probate costs. **ANOTHER WISE MOVE TO SAVE POTENTIAL PROBATE COSTS IS TO HAVE AS MUCH PROPERTY AS POSSIBLE PASS DIRECTLY TO HEIRS. THIS CAN BE DONE WHEN THEY ARE NAMED BENEFICIARIES ON LIFE INSURANCE POLICIES, RETIREMENT PLANS, AND ANNUITY CONTRACTS, OR WHEN THEY HOLD TITLE TO PROPERTY AS JOINT TENANT WITH RIGHT OF SURVIVORSHIP.** Right of survivorship simply means the other owner(s) directly inherits the deceased's share of the property.

Granting the executor of an estate the power to settle will disputes and sell estate property if needed can help to reduce probate costs

LIFE INSURANCE

LIFE INSURANCE PROCEEDS CREATE AN INSTANT ESTATE. The proceeds also protect an existing estate from losing money since the policy can cover probate costs and estate taxes. The advantage of life insurance is that the proceeds pass directly to heirs with no taxes due.

Minor children cannot receive life insurance proceeds

BE SURE TO NAME PRIMARY AND SECONDARY BENEFICIARIES IN ALL POLICIES. A primary beneficiary is the first in line to receive the proceeds. A secondary beneficiary is the second in line and only receives the proceeds if the primary beneficiary is not living. Again, do not name minor children as primary beneficiaries unless you also set up a trust to manage the funds for the benefit of the children. Minor children cannot receive proceeds; they need a guardian to manage the money.

STEPPED-UP BASIS

Beneficiaries inherit property at the current market value. This is called stepped-up basis

If you own appreciated assets, such as real estate or securities, you can hold them in joint tenancy with a beneficiary. Upon your death, ownership passes to the beneficiary at its current market value. **THIS IS CALLED A "STEPPED-UP" BASIS BECAUSE BENEFICIARIES INHERIT PROPERTY AT THE CURRENT MARKET VALUE, NOT THE PURCHASE PRICE.** The "stepped-up" basis has a big tax advantage for beneficiaries should they decide to sell the asset. The only taxable gain will be the difference between the inherited market value and the sales price. Whereas, if you, as owner, sell an appreciated asset, your taxable gain will be on the full difference between the market value and the original purchase price.

Example:

A mother holds several stock certificates in joint tenancy with her daughter. The stock has a market value of $80,000. The purchase price was $12,000. When the mother dies, the daughter inherits the stock at its current market value on the day of death, or $80,000. If the daughter immediately sells the stock for $80,000, she has no taxable gain because the basis and selling price of the stocks are the same. If the daughter sells the stock one year later for $82,000 she would have a $2,000 taxable gain, the difference between the inherited value and the selling price. Had the mother sold the stock immediately before her death, she would have had a taxable gain on $68,000, the difference between the $12,000 cost and the $80,000 sales price. This example holds true for all appreciated assets, including real property.

TRUSTS

SEEK COMPETENT ADVICE FROM AN ESTATE PLANNING ATTORNEY IF THE VALUE OF ALL OF YOUR ASSETS EXCEEDS $600,000. Included in the estate's value are: the market value of all real property, the market value of all securities, the cash value of life insurance, the value of all retirement plans, plus the value of all other assets. **SETTING UP A TRUST CAN AVOID MANY UNNECESSARY TAXES, NO SMALL MATTER SINCE ESTATE TAXES ARE CONSIDERABLE, RANGING FROM 37% TO 55%. WITHOUT PROPER PLANNING, ESTATE TAXES CAN GREATLY REDUCE AN ESTATE, AND HEIRS WILL RECEIVE MUCH LESS THAN INTENDED.** If an estate is worth more than $600,000, it is subject to federal estate taxes and needs to file an estate tax return nine months after the death.

Seek competent advice from an estate planning attorney if the value of all your assets exceeds $600,000

TRUSTS ARE COMPLICATED AND COME IN MANY VARIETIES, SO MAKE CERTAIN YOU SEE AN ATTORNEY WHO SPECIALIZES IN ESTATE PLANNING. Trusts are created by a person called the trustor (grantor) and administered by a trustee for the benefit of a third party, or beneficiary. The trustor can give specific directions to the trustee on how to disperse and manage the assets. In some cases, the trustor can also be the trustee.

A LIVING TRUST avoids probate and allows total flexibility for the person(s) making the trust. Also, it can take the place of a will. **A TESTAMENTARY TRUST** is created as part of a valid will. It does not come into existence until the death of the will maker. Before the death, the testamentary trust can always be canceled or changed. Some non-testementary trusts can be changed, others cannot, and they all have various tax consequences.

Overall, trusts allow for tax savings, management of investments, transfer of assets to minors, and minimum probate costs. When established, they become their own taxable entity and must then file a separate "trust" tax return.

Trusts allow for tax savings, management of investments, transfer of assets to minors, and minimum probate costs

ONCE AGAIN, IF YOUR ESTATE IS VALUED OVER $600,000, SEE AN ESTATE PLANNING ATTORNEY. This is true even if you plan to pass everything to your spouse and avoid estate taxes with the $600,000 marital deduction. It is important to note that the majority of taxes become due not when the first spouse dies, but when the second spouse (primary beneficiary of first spouse) dies.

MANY PEOPLE GIVE LITTLE PRIORITY TO ESTATE PLANNING. YET, WITHOUT IT, AN UNTIMELY DEATH CAN LEAVE MUCH UNFINISHED BUSINESS FOR SURVIVORS. Take the time to seek competent counsel to draft a will, a trust, or both. If you have minor children, own a home, or have assets worth more than $600,000, estate planning is most important. Otherwise, taxes and expensive probate costs can eat away at your estate until little is left for intended heirs.

Chapter 18

Funding Goals

FINDING THE MONEY TO FUND YOUR GOALS

To improve your net worth, make a commitment to get some money working for you. If you wait until you have money "leftover" to start building a nest egg, time will pass, and then it will be too late. **TAKE YOUR SAVINGS AND INVESTMENT DOLLARS OFF THE TOP OF YOUR PAYCHECK BEFORE YOU START SPENDING.**

ACTION!

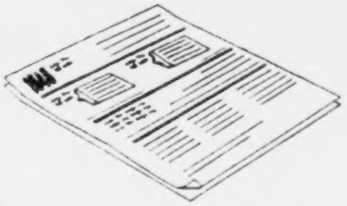
If we had no withholding, how many people would be in trouble on April 15 because they wouldn't have the money to pay their income taxes? State and federal taxing agencies know that they need to take their revenues out of gross pay before citizens take it home. Do the same for yourself. Save some money off the top before you take it home. Pretend this savings is a tax increase that reduced your take home pay. Aim to save 10% of your gross pay. If this is too much, start with a smaller percentage and increase the amount as quickly as you can.

**Aim to save
10% of your gross pay**

If your cash flow shows you need every dime, hope still exists. Three "pockets" could be holding some extra money for you. They are:

- **TAX SAVINGS**
- **EXPENSE REDUCTIONS**
- **MORE INCOME**

TAX SAVINGS



Look at last year's tax return. **DID YOU GET A LARGE REFUND? IF YOU DID, YOU ARE HAVING TOO MUCH WITHHELD.** You can start investing or saving that refund money each month and benefit from the earnings instead of giving Uncle Sam free use of your money. Form W-4, used by employers, decides the amount of withholding taken out for taxes. Most importantly, you have some control over the amount your employer sends in on your behalf. Tax law says that taxpayers with taxable incomes under $150,000 only need to pay in an amount equal to their previous year's taxes, or 90% of their current year's tax bill, whichever is less. Staying within these limits avoids all penalties. At the same time, do careful estimates and don't make the mistake of underpaying and then owing taxes in addition to penalties on April 15. Such poor planning can ruin your attempt to get ahead. **YOU MUST HAVE A LEGITIMATE REFUND DUE TO DECREASE YOUR WITHHOLDING AND USE THAT EXTRA MONEY THROUGHOUT THE YEAR.**

**Have withheld from your pay 90%
of what you expect to owe, or
what you owed last year,
and no more!**

You control your withholding by the filing status and the number of exemptions you claim on the W-4. If you are single and claim "married with 10 dependents" on your W-4, it's O.K. However, you must claim your correct filing status and correct number of dependents on your tax return. The purpose of Form W-4 is to decide a withholding amount. If you claim more than ten exemptions, the IRS may ask you to justify your deductions.

**Your control your withholding
by the filing status and
the number of exemptions
claimed on Form W-4**

Many people judge their taxes by their refund, not by what they pay. This thinking needs to be reversed. **PARKING 'EXTRA' MONEY WITH UNCLE SAM GIVES YOU NO EARNINGS, AND YOUR MONEY ISN'T ACCESSIBLE UNTIL YOUR REFUND CHECK ARRIVES.**

Any event that saves you taxes allows you to decrease your withholding. Some of these events include: adding a dependent, buying a new home, having a deductible capital or ordinary loss, contributing to a tax deferred savings plan, and many others. Reducing taxable income usually means a refund, and that refund allows you to decrease your withholding.

**Any event that saves you taxes,
allows you to decrease
your withholding**

As often as needed, do an annual tax projection calculating what you expect to owe in tax. Most libraries keep copies of the current year's tax rates and withholding tables. After doing the projection, divide the expected tax by your number of yearly pay periods, such as 12, 26, or 52. Then use the current withholding tables to figure out how many exemptions you need to claim to have the amount you expect to owe, and nothing more, taken out of your paycheck. The extra money is yours to save or invest now.

Annual tax projections are not difficult. Refer to Chapter 7, *Personal Income Taxes* and the annual tax projection form in Chapter 16, *Planning.* Get in the habit of doing a tax projection when some event may change the amount of tax you will owe. If you are uncomfortable with the tax projection process, call a tax professional for help and advice.

CUTTING EXPENSES

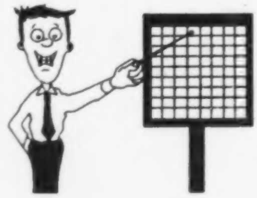
Will you have any loans that soon will be paid off? If so, this expense reduction can have the effect of raising your income. **THE INCREASED CASH FLOW BECOMES AN EXCELLENT SOURCE FOR NEW SAVINGS.**

If excessive consumer debt is putting you under, take steps to reverse the situation. Consider bill consolidation through a home equity loan or an alternative source to reduce your outflow and give you more available cash. Sometimes, this is the only way to get out from under the huge monthly payments that tie up all your money. If you do this, you must stop ongoing credit card charging and unnecessary spending. Trading "bad" debt for "good" debt won't work if you keep adding to the balance of the "bad." The amount paid for finance charges and interest is money you put directly into the pockets of someone else. Cut or reduce your finance charges and use this same money to fill your own pockets.

PAYMENT
DUE

MORE MONEY

If tax savings and cutting expenses won't help, then you need to look at bringing in more money. Can you take an extra job? Can you start a part-time business? Can you work overtime? Can your spouse work part-time or in the evening? **YOU MUST BE CREATIVE AND OPTIMISTIC ABOUT FINDING WAYS TO GET SOME EXTRA MONEY.**



TWO CASES

Carl Smith

How A Home Purchase Helped Carl Reduce His Taxes And Start An Investment Plan

The following two cases illustrate how an appropriate action can help you fund your goals with little change in "spendable" income.

Carl, 36 years old and single, earns approximately $45,000 a year as a foreman for a utility company. Two years ago he purchased a condominium for $135,000. He put $10,000 down and assumed a $125,000 mortgage at 8% interest. His mortgage payment is $1,050 a month, $915 for the loan and $135 for the impound account for insurance and taxes. Prior to buying the condo, he was paying $800 a month for rent. For the past two years, Carl has received tax refunds of approximately $4,000. The first year he used this money to help furnish the condo, the next year he used his refund money to take an extended vacation. Table 18.1 shows Carl's expenses before and after the condo purchase. The figures show that he had $1,821 more spendable income after purchasing the condo and assuming the larger monthly payment ($24,012 - $22,191 = $1,821).

Table 18.1 EXPENSES BEFORE AND AFTER CARL'S CONDO PURCHASE

Before:	**Expenses**	**After:**
8,195	Federal Tax	4,569
2,775	State Tax	1,580
3,442	FICA	3,442
9,600	Rent / Mortgage Payment	12,600
24,012	**Total Expenses**	**22,191**

The home mortgage interest and property tax deductions on **SCHEDULE A, ITEMIZED DEDUCTIONS** helped reduce his total federal and state tax bill by $4,821 ($8,195 - $4,564 = $4,821). Table 18.2, *Carl's Taxes Before and After the Condo Purchase*, shows the tax breakdown. Additionally, having the mortgage payment now allows Carl to deduct other expenses such as state taxes and charitable contributions that he could not take before as a "renter." While renting, Carl claimed the standard deduction for single persons, and for that year it was $3,800. After buying the condo, his itemized deductions totalled $16,566. The larger itemized deductions reduced his taxable income.

Table 18.2 TAXES BEFORE AND AFTER THE CONDO PURCHASE

Before:		**After:**
45,144	Income	45,144
- (3,800)	Standard Deduction	0
0	Itemized Deductions	- (16,566)
- (2,450)	Personal Exemption	- (2,450)
38,894	**Taxable Income**	**26,128**
8,012	Federal Taxes	4,442
2,775	State Taxes	1,580

Since Carl has $3,600 in savings but no investments, he decided to invest most of next year's anticipated $4,000 tax refund. Since Carl preferred to receive his "refund" early, he changed his withholding on Form W-4 to have $300 less taken out of his pay each month for federal and state taxes ($3,600 annually). He used this money to start his investment program. He started contributing $100 a month to his employer's 401(k) plan. In addition, he opened a check-o-matic plan with a mutual fund for $200 a month. After taking this action, Carl's spendable monthly income remained the same, but he received much smaller tax refunds, approximately $400 per year.

THE PURCHASE OF THE CONDO BECAME THE CATALYST THAT GOT MORE ASSETS WORKING FOR CARL. BY REDUCING HIS TAXES, HE HAD AN EXTRA $300 EACH MONTH TO INVEST. As Table 18.3 shows, Carl's net worth grew substantially in ten years. The condo only appreciated 2% a year. The mutual fund earned an average compound rate of 12.8%, and the 401(k) plan earned 8%, tax deferred. His savings account grew by 3%. Notice that the market value of the condo has increased and the mortgage balanced has declined; the difference adds to Carl's personal net worth. This equity build-up is a benefit of home ownership that can not be realized by renting.

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Table 18.3 NET WORTH

Carl's Net Worth Year of Condo Purchase

Savings	3,600	Mortgage	125,000
Condo*	135,000		
Assets	**138,600**	***Liabilities***	**125,000**

Net Worth = $13,600

Carl's Net Worth 10 Years Later

Savings	4,838	Mortgage	109,468
Mutual Fund	46,294		
401(k)	18,866		
Condo*	164,500		
Assets	**234,498**	***Liabilities***	**109,468**

Net Worth = $125,030

*Market Value

Phil and Mary Piper

Bill Consolidation Through A Home Equity Loan, Or Refinancing

Phil and Mary Piper both work, are in their late thirties, and have four children. They purchased a home several years ago. Although their joint incomes are above average, they can't keep up with their expenses. They are in a 35% tax bracket: 28% federal and 7% state. Their taxable income for the past year was $48,000, and they owed more taxes in addition to their withholding. They want to get ahead, but nothing has worked yet.

Although they jointly earn $3,765 each month, they always spend more than they earn. Phil and Mary try not to charge, but things come up that they need for the children or the house and they seldom have the extra cash to pay for it. Over the past three years, their charge card balances have grown. They also realize that taxes take a larger and larger bite each year. They want to pay off their credit cards to free some extra money, but don't have enough leftover at the end of the month to make any additional installment payments. Their biggest problem is a negative cash flow. This is due to a large amount of consumer debt. Following are their annual cash flow and net worth statements:

Table 18.4 CASH FLOW STATEMENT BEFORE REFINANCING

CASH FLOW STATEMENT (Annual)

INCOME		EXPENSES	
Salaries (Gross)	62,100	Federal Tax	5,630
		State Tax	2,400
		FICA	4,752
		Insurance	2,160
		Mortgage	12,228
		Car Loan #1	4,980
		Car Loan #2	3,192
		Credit Cards	7,200
		Food	8,000
		Clothing	2,400
		Household \ Yard	900
		Auto Maintenance \ Gas	3,433
		Misc. & Children	6,000
Total Income	62,100	Total Expenses	63,275

NET INCOME AFTER EXPENSES ($1,235)

Table 18.5 NET WORTH STATEMENT BEFORE REFINANCING

NET WORTH STATEMENT (Annual)

ASSETS		LIABILITIES	
Home (Market Value)	185,000	Home Mortgage	97,000
Retirement Plan	32,000	Auto Loan #1	12,500
Cars (Value)	15,000	Auto Loan #2	7,000
Savings	200	Credit Cards	14,000
Total Assets	**232,200**	**Total Expenses**	**130,500**

NET WORTH: $101,700

Their net worth statement shows that they only have $200 in liquid assets (savings account). Their only investment is Phil's retirement plan. Their largest asset is the $88,000 equity in their home.

Their original mortgage was for 10.5% and rates are now at 7.5%. They feel the only way they can get ahead is to refinance their home and use the money to pay off their credit cards

and car loans. They qualify for a loan of $148,000, which is 80% of $185,000, their home's market value (most lending institutions will loan this 80% to value on home mortgages). They discussed the pros and cons of refinancing, and considered different loan amounts. They decided to take the maximum.

The refinancing increased their home mortgage from $97,000 to $148,000. Their monthly mortgage payment changed from $915 to $1,035. The payment only increased by $103 because their interest rate dropped from 10.5% on the old loan to 7.5% on the new loan.

REFINANCING INFORMATION

Total Loan Proceeds	148,000
Minus	
Points & Fees	- (2,960)
Pay off old mortgage	-(97,000)
Pay off credit cards	-(14,000)
Pay off auto loan #1	-(12,500)
Pay off auto loan #2	- (7,000)
BALANCE LEFT	**14,540**

New Monthly Payment	1,035
Insurance & Taxes	231
Total	1,266

New mortgage of $148,000 @ 7.5% interest has monthly payments of $1,035.
No change in insurance and taxes.

They used most of the $14,540 balance from the loan proceeds to start the funding of their financial goals. They spent the money as follows:

Money Market Fund	5,000
Bank Savings Account	2,000
Mutual Fund	5,000
Universal Life Policy	2,500
TOTAL INVESTED	**14,500**

Their new cash flow statement looks much brighter, and their new net worth statement shows possibility for more growth. The new loan reduced their taxes and paid off their nondeductible consumer debt, thus reducing their overall expenses. After refinancing, their cash flow and net worth statements reflect the following:

- ✓ Their joint salaries remain the same
- ✓ Their mortgage payment is higher

- ✓ Their federal and state taxes are now lower due to more deductible home mortgage interest
- ✓ They purchased needed life insurance, paying $1,800 annually for the policy
- ✓ They have no consumer debt
- ✓ They have an extra $11,614 each year after paying all expenses
- ✓ Their net worth decreased due to refinancing and assuming a higher mortgage, but overall it shows more potential for future growth

Table 18.6 CASH FLOW STATEMENT AFTER REFINANCING

INCOME		EXPENSES	
Salaries (Gross)	62,100	Federal Tax	5,149
		State Tax	2,500
		FICA	4,752
		Insurance	2,160
		Mortgage	15,192
		Food	8,000
		Clothing	2,400
		Household \ Yard	900
		Auto Maintenance \ Gas	3,433
		Misc. & Children	6,000
TOTAL INCOME	**62,100**	**TOTAL EXPENSES**	**50,486**

NET INCOME AFTER EXPENSES $11,614

Table 18.7 NET WORTH STATEMENT AFTER REFINANCING

ASSETS		LIABILITIES	
Home (Market Value)	185,000	Home Mortgage	148,000
Retirement Plan	32,000		
Cars (Value)	15,000		
Savings	2,200		
Money Market Fund	5,000		
Mutual Fund	5,000		
Total Assets	**244,200**	**Total Expenses**	**148,000**

Net Worth: $96,200

By repositioning their assets, they now have extra money working for them. Now instead of one large asset (home equity), they have several more liquid assets growing at a higher rate of return. In addition, their home value continues to increase at 2% each year. After refinancing, Mary and Phil were able to stay out of debt. They had the extra money to start investing $750 monthly. They decided to put this money into two mutual funds. They added $350 monthly to Fund A, which they had already established. Then they opened another fund and made contributions of $400 monthly. Ten years, later, their net worth statement showed the value of paying off their consumer debt and consistently contributing to their growing assets.

Table 18.8 NET WORTH STATEMENT TEN YEARS AFTER REFINANCING

NET WORTH STATEMENT

(Annual growth rate is shown by each asset)

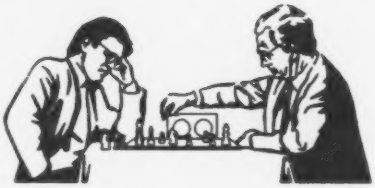
	Assets		Liabilities	
2.0%	Home (Market Value)	230,024	Home Mortgage	133,507
8.0%	Retirement Plan	68,800		
3.0%	Savings	2,957		
5.0%	Money Market Fund	8,144		
11.9%	Mutual Fund A ($5,000 plus $350 monthly for ten years)	96,382		
12.3%	Mutual Fund B ($400 monthly for ten years)	93,654		
	Cash Value Life Ins.	27,127		
	TOTAL ASSETS	**527,088**	**TOTAL EXPENSES**	**133,507**

NET WORTH: $393,581

SUMMARY

As you can see from reading the two cases, once you put money to work, the miracle of compounding takes over. With enough time, even small amounts create future fortunes with income you won't be able to outlive. **THE KEY TO FINANCIAL SECURITY IS TAKING THE TIME TO LOOK CLOSELY AT HOW YOU SPEND, INVEST, AND SAVE WHAT YOU HAVE.**

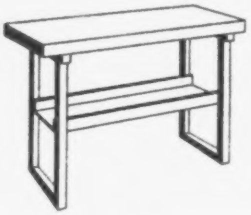
DISCOVER YOUR AREA OF EXCELLENCE



SOMETIMES, FINANCIAL GROWTH IS A STALEMATE BECAUSE OF A DEAD-END JOB. People who dislike their work seldom advance. Therefore, knowing your talents is equally important to having financial priorities. Take care when assessing your potential not to overemphasize your limitations and understate your abilities. **MOST PEOPLE TEND TO DWELL ON WHAT THEY DON'T DO WELL INSTEAD OF EMPHASIZING THEIR STRONG POINTS. YOUR NATURAL SKILLS LEAD TO YOUR SUCCESS.**

YOU HAVE ONE TALENT THAT SURPASSES ALL OTHERS. You can identify it by what you love to do and what you do well. Developing this talent is most important; it is your area of excellence. Success here has less resistance, and will positively influence all other facets of your life.

EXAMPLE ONE: ED



Ed never attained high grades in school. Yet, even as a boy he could fix any tool or toy. Ed began working in construction as a cabinet maker. He was a good craftsman, but never liked his job. What he did like was when the other workers asked him to help repair their broken equipment.

Eventually, Ed quit his construction job and took the risk of opening a repair shop for tools and small appliances. His enthusiasm for his work led to many referrals from satisfied customers, which made his business thrive. Soon, he had to hire people to work for him. Once Ed started using his natural abilities in his job, his income and confidence grew and he became happier.

EXAMPLE TWO: JAYNE

Jayne loved all animals, especially dogs. Upon completion of high school she had to leave the farm where she was raised and move to the city to work. Jayne went to secretarial school and eventually secured a good job with a large corporation. It took her several years before she realized that she disliked her work. In time, Jayne got involved with a group of people who bred and showed dogs. Through contacts in this group, she saw the potential of starting a dog grooming business.

Jayne launched her business part-time, working from her home. Soon she had a steady customer list that kept growing. Before long, she quit her secretarial job to devote full-time efforts to her grooming business. She was happier doing what she loved. Her substantial increase in income was another reward.

IF YOU FIND YOURSELF IN A DEAD-END JOB THAT DRAINS YOUR ENTHUSIASM, SERIOUSLY CONSIDER A CHANGE. WHAT IS YOUR AREA OF EXCELLENCE? Others can benefit from your developing this talent. Furthermore, as they benefit, you will be happy doing what you do best. Like Ed and Jayne, you will also probably earn more money—definitely a win-win situation.

FUNDING YOUR GOALS

It can't be said enough. **TO MAKE MONEY, YOU MUST GET MONEY WORKING FOR YOU.** You have a creative right-brain and can find a way. If desire isn't enough, perhaps the following tables will provide further incentive.

Table 18.9 PERSONAL SAVINGS RATE OF U.S. CITIZENS[20]

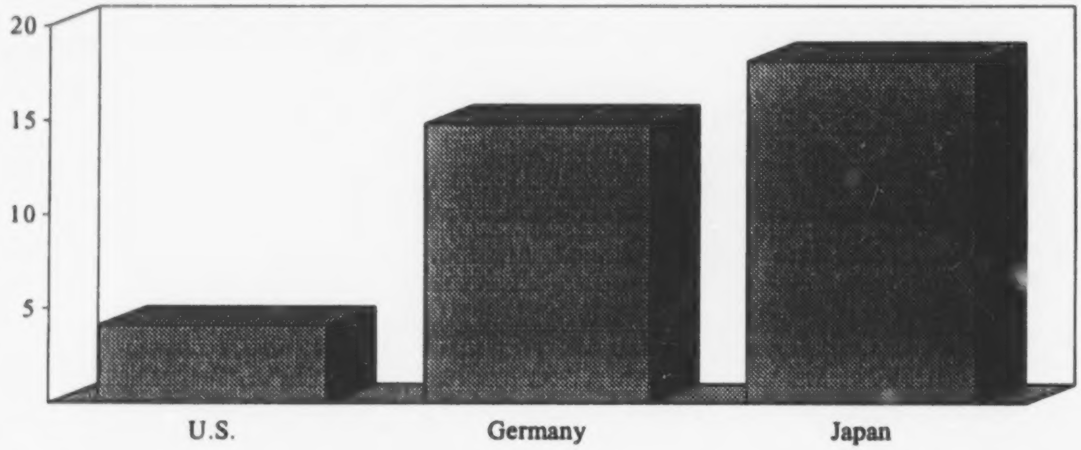


Table 18.10 THE REALITIES OF INFLATION..... HOW PRICES ARE INCREASING

	20 YEARS AGO	TODAY	IN 20 YEARS
Average Car	$ 3,742	$ 16,692	$ 74,458
1 Year Public College	1,621	4,852	14,523
Average Home	24,910	100,299	403,849
Bag of Groceries	5	13	33

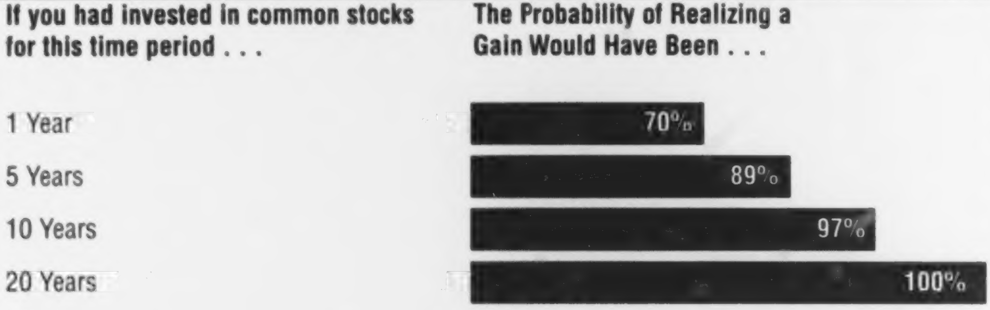
Sources: U.S. Bureau of the Census, WEFA Group, U.S. Dept. of Education: Digest of Education Statistics, U.S. Bureau of Labor Statistics, U.S. Dept. of Commerce. Future prices estimated at same rate as they grew over the last 20 years. Of course, there is no guarantee that past inflation trends will continue in the future.

Table 18.11 LONG-TERM SAVER'S GUIDE: AVERAGE RATES OF RETURN

Years	Stock Market	Treasury Bonds	Money Market	Inflation
64	10.3%	4.6%	3.6%	3.1%
10	17.3%	12.6%	9.5%	4.8%
5	17.7%	12%	7%	3.8%

Source: Ibbotson Associates, U.S. News & World Report

Table 18.12 THE BENEFITS OF LONG-TERM INVESTING



Based on historical annual rates of return (income plus capital changes), 1926 - 1991. Figures are not meant to represent performance of any specific fund. Source: "Stocks, Bonds, Bills, and Inflation 1992 Yearbook," Ibbotson Associates.

Table 18.13 TIME IS YOUR GREATEST ALLY

Investments Of	$ 20 Monthly @ age 25	**Produces Same Results At Age 65**
	$ 60 Monthly @ age 35	
	$200 Monthly @ age 45	
	$850 Monthly @ age 55	

PROCRASTINATION IS A DEADLY ENEMY

SUMMARY

THE INFORMATION PRESENTED THROUGHOUT THIS BOOK HAS TWO PRIMARY GOALS:

❶ TO HELP YOU GET MORE OF YOUR MONEY WORKING FOR YOU

❷ TO SHOW YOU THE IMPORTANCE OF SAVING AND INVESTING A PORTION OF EVERYTHING YOU EARN

USE THIS BOOK OFTEN AS A REFERENCE, TO ANSWER QUESTIONS, TO LOOK UP INFORMATION, AND TO PUT YOUR HARD-EARNED MONEY TO ITS WISEST USE.

Heading For
The Future

APPENDIX

FEDERAL RESERVE BANKS

Treasury issues can be purchased directly from any of the twelve federal reserve banks. In order to purchase, write or call the nearest bank and ask for the necessary forms. Submit the form along with your payment to purchase any treasury offering. By purchasing directly, you will save the fees charged by local commercial banks and by brokers.

Table A-1 FEDERAL RESERVE BANKS

ATLANTA	104 Marietta Street N.W., Atlanta, GA 30303 (404) 586-8500
BOSTON	600 Atlantic Avenue, Boston, MA 02106 (617) 973-3000
CHICAGO	230 South LaSalle Street, P.O. Box 834, Chicago, IL 60690 (312) 322-5322
CLEVELAND	1455 East Sixth Street, P.O. Box 6387, Cleveland, OH 44101 (216) 241-2800
DALLAS	400 South Akard Street, Station K, Dallas, TX 75222 (214) 651-6111
KANSAS CITY	925 Grand Ave., Federal Reserve Station, Kansas City, MO 64198 (816) 881-2000
MINNEAPOLIS	250 Marquette Ave., Minneapolis, MN 55480 (612) 340-2345
NEW YORK	33 Liberty Street, Fed. Reserve P.O. Station, New York, NY 10045 (212) 791-5000
PHILADELPHIA	100 North Sixth Street, P.O. Box 66, Philadelphia, PA 19105 (215) 574-6000
RICHMOND	701 East Byrd Street, P.O. Box 27622, Richmond, VA 23261 (804) 643-1250
ST. LOUIS	411 Locust Street, P.O. Box 442, St. Louis, MO 63166 (314) 444-8444
SAN FRANCISCO	400 Sansome Street, P.O. Box 7702, San Francisco, CA 94120 (415) 544-2000

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HOW LONG WILL YOUR MONEY LAST?

Table A-2 shows how many years a sum lasts at various withdrawal rates and various rates of return. If the withdrawal rate and the rate of return are the same, the principal will not change. For example, when $100,000 earns 8% per annum ($8,000), and $8,000 or 8% is withdrawn, the principal stays the same. However, if $100,000 earns 4% per annum ($4,000), and 8% ($8,000) is withdrawn annually, the $8,000 annual income will continue for seventeen years before the principal is gone.

The rate of return and the withdrawal rate determine how many years the principal will last. When the earnings are less than the amount taken out, you are dipping into principal, so your money will not last indefinitely.

Table A-2 HOW LONG WILL YOUR MONEY LAST?

Payout Rate	Annual Growth Rate of Investment										
	3%	4%	5%	6%	7%	8%	9%	10%	11%	12%	13%
13%	8	9	9	10	11	12	13	15	17	21	
12%	9	10	11	11	12	14	15	18	23		
11%	10	11	12	13	14	16	19	25			
10%	12	13	14	15	17	20	26				
9%	13	14	16	18	22	28					
8%	15	17	20	23	30						
7%	18	21	25	33							
6%	23	29	36								
5%	30	41									
4%	46										
3%											
	Number of Years Money Will Last										

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TAX BRACKET

Federal Tax Rates

Table A-3 FEDERAL TAX RATES—1995

Beginning Of:	Single	Married Filing Joint	Married Filing Separate	Head of Household
15%	0	0	0	0
28%	23,350	39,000	19,500	31,250
31%	56,550	94,250	47,125	80,750
36%	117,950	143,600	71,800	130,800
39.6%	256,500	256,500	128,250	256,500

TAX YEAR 1995

Personal Exemption:	$2,500
Standard Deduction:	
Single	$3,900
Married Filing Joint	$6,550
Married Filing Separate	$3,275
Head of Household	$5,750

State Tax Rates

Add the state tax rate to your federal tax rate for your true marginal tax bracket.

For Example:

If your state tax rate is 6% and your federal tax rate is 28%, your combined tax bracket would be 34% (6% + 28% = 34%).

You can use your tax bracket to make financial planning decisions. The calculation will be close, but not exact, because of variables such as tax credits and state taxes that are deductible on a federal return. Also, taxpayers in the higher brackets are subject to phaseouts of itemized deductions and personal exemptions.

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Table A-4 STATE TAX RATES

STATE	TAXABLE INCOME BRACKETS		
	Tax Rates in %	**Lowest Amount Under:**	**Highest Amount Over:**
ALABAMA	2% - 5%	$500	$3,000
ALASKA	No State Income Tax		
ARKANSAS	1% - 7%	$3,000	$25,000
ARIZONA	3.8% - 7%	$10,000	$150,000
CALIFORNIA	1% - 11%	$4,374	$100,000
COLORADO	5% of Modified Federal Taxable Income		
CONNECTICUT	1.5%	Flat Rate	
DELAWARE	3.2% - 7.7%	$2,000	$40,000
DISTRICT OF COLUMBIA	5% - 9.5%	$10,000	$20,000
FLORIDA	No State Income Tax		
GEORGIA	1% - 6%	$750	$7,000
HAWAII	2% - 10%	$1,500	$20,500
IDAHO	2% - 8.2%	$1,000	$20,000
ILLINOIS	3%	Flat Rate	
INDIANA	3.4%	Flat Rate	
IOWA	.4% - 9.98%	$1,060	$47,700
KANSAS	4.5% - 5.95%	$27,500	$27,500
KENTUCKY	2% - 6%	$3,000	$8,000
LOUISIANA	2% - 6%	$10,000	$50,000
MAINE	2.1% - 9.89%	$4,150	$37,500
MARYLAND	2% - 6%	$1,000	$3,000
MASSACHUSETTS	5.95% - 12%	Flat Rate	
MICHIGAN	4.6%	Flat Rate	
MINNESOTA	6% - 8.5%	$13,620	$44,750
MISSISSIPPI	3% - 5%	$5,000	$10,000
MISSOURI	1.5% - 6%	$1,000	$9,000
MONTANA	2% - 11%	$1,600	$57,600
NEBRASKA	2.37% - 6.92%	$1,800	$27,000
NEVADA	No State Income Tax		
NEW HAMPSHIRE	Limited Income Tax		
NEW JERSEY	2% - 3.5%	$20,000	$75,000
NEW MEXICO	1.8% - 8.5%	$5,200	$41,600
NEW YORK	4% - 7.88%	$5,500	$13,000
NORTH CAROLINA	6% - 7.75%	$12,750	$60,000
NORTH DAKOTA	2.67% - 12%	$3,000	$50,000

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Table A-4 STATE TAX RATES (cont.)

STATE	TAXABLE INCOME BRACKETS		
	Tax Rates in %	**Lowest Amount Under:**	**Highest Amount Over:**
OHIO	.74% - 6.9%	$5,000	$100,000
OKLAHOMA	5% - 7%	$1,000	$9,950
OREGON	5% - 9%	$2,000	$5,000
PENNSYLVANIA	2.1%	Flat Rate	
RHODE ISLAND	27.5% of Federal Tax Liability		
SOUTH CAROLINA	2.5% - 7%	$2,070	$10,350
SOUTH DAKOTA	No State Income Tax		
TENNESSEE	Limited Income Tax		
TEXAS	No State Income Tax		
UTAH	2.55% - 7.2%	$75	$3,750
VERMONT	28% - 34% of Federal Income Tax Liability		
VIRGINIA	2% - 5.75%	$3,000	$17,000
WASHINGTON	No State Income Tax		
WEST VIRGINIA	3% - 6.5%	$10,000	$60,000
WISCONSIN	4.9% - 6.93%	$7,500	$15,000
WYOMING	No State Income Tax		

Add your federal tax rate to your state tax rate for your combined tax bracket.

FEDERAL TAX RATES				
15%	28%	31%	36%	39.6%

Federal Tax Rate + State Tax Rate = Tax Bracket

COMMUNITY PROPERTY STATES

Table A-5 COMMUNITY PROPERTY STATES

ARIZONA	NEW MEXICO
CALIFORNIA	TEXAS
IDAHO	WASHINGTON
LOUISIANA	WISCONSIN
NEVADA	

SOCIAL SECURITY BENEFITS

To be eligible for social security benefits, a person must have credit for work under social security. Credits are earned by working in employment covered by the law after 1936, and working in self-employment covered by the law after 1950. A working person can earn a maximum of 4 credits per year. No benefits are payable if employment ends before earning enough credits to qualify.

For a worker and his or her dependents to be eligible for most benefits, the worker must be fully insured. The wages earned during the eligibility time help determine the amount of benefits paid. A person who reaches age 62 after 1991 must have 40 credits or 10 years of service to be fully insured.

Maximum Earnings

The maximum earnings in any one year that count toward social security are set by law. The following table shows the maximum eligible earnings for each year since 1972.

Table A-6 MAXIMUM ELIGIBLE EARNINGS

Year	Annual Maximum
1972	$9,000
1973	$10,800
1974	$13,200
1975	$14,100
1976	$15,300
1977	$16,500
1978	$17,700
1979	$22,900
1980	$25,900
1981	$29,700
1982	$32,400
1983	$35,700
1984	$37,800
1985	$39,600
1986	$42,000
1987	$43,800
1988	$45,000
1989	$48,000
1990	$51,300
1991	$53,400
1992	$55,500
1993	$57,600
1994	$61,200
1995	$61,200
1996	$62,700

BENEFIT ESTIMATE STATEMENT

An eight page document called *Earnings and Benefit Estimate Statement* can be ordered from the Social Security Administration to show what you have paid in to date. Based on your current earnings, they will project what you will receive in retirement benefits, disability benefits, and survivor benefits. Call 1-800-772-1213 and ask for Form SSA-7004 to order your personal *Earnings and Benefit Estimate Statement.*

Age Full Benefits Begin

For a person born in 1937 or earlier, the normal retirement age is age 65. For all persons born after 1937, they must be over age 65 to collect full benefits. The following table shows at what age a person can collect full benefits.

Table A-7 AGE FULL SOCIAL SECURITY BENEFITS BEGIN

YEAR BORN	AGE FULL BENEFITS BEGIN
1938	65 years, 2 months
1939	65 years, 4 months
1940	65 years, 6 months
1941	65 years, 8 months
1942	65 years, 10 months
1943-1954	66 years, 0 months
1955	66 years, 2 months
1956	66 years, 4 months
1957	66 years, 6 months
1958	66 years, 8 months
1959	66 years, 10 months
1960 & Later	67 years, 0 months

WHEN IS A PERSON DISABLED?

To be considered disabled, a person must have a physical or mental condition which:

- Prevents worker from doing any gainful, substantial work, AND
- Is expected to last (or has lasted) for 12 months, or is expected to result in death

Medical evidence from a physician must show that the worker is prevented from working. If the worker can do any job that is substantial and gainful, he or she is not considered disabled under Social Security law.

When a person receives social security disability, monthly benefits can also be paid to certain dependent family members:

- Unmarried child under age 18
- A child disabled before age 22 who is over the age of 18
- A spouse who cares for the disabled worker's child who is under age 16, or a child disabled before age 22
- A spouse who is 62 or older

Work Credits Needed for Disability

The work credits needed depend upon the age of the worker when he or she became disabled.

• **Before age 24**	6 credits in the 3 year period ending when the disability starts.
• **Ages 24 through 30**	Credit for working half the time between age 21 and the age of disability.
• **Age 31 or older**	Same number of credits as needed for retirement benefits.
• **Blind person**	1 credit for each year since 1950, or since becoming age 21 if that is later.

APPROXIMATE SOCIAL SECURITY BENEFITS

The approximate benefit assumes the worker has had 6% pay raises each year through 1993. The calculations also assume the worker's current earnings will stay the same until the normal retirement age.

The following two tables show projected benefits for retirement, death, and disability. You need to take your AIME number to Table A-10 to determine approximate monthly retirement and survivor benefits. Use Table A-11 for disability benefits.

Table A-8 AIME FOR WORKERS EARNING $21,000 TO $41,000

AIME—Average Indexed Monthly Earnings For Workers Earning $21,000 - $41,000					
YEAR BORN	**AIME (Average Indexed Monthly Earning)**	**CURRENT ANNUAL INCOME**			
		$21,000 to $25,000	**$26,000 to $30,000**	**$31,000 to $35,000**	**$36,000 to $41,000**
1931	Retirement	$1,685	$2,015	$2,260	$2,491
	Death	$1,661	$1,974	$2,195	$2,402
	Disability	$1,648	$1,952	$2,162	$2,357
1932 to 1936	Retirement	$1,718	$2,067	$2,348	$2,615
	Death	$1,675	$2,005	$2,247	$2,474
	Disability	$1,663	$1,985	$1,985	$2,428
1937 to 1941	Retirement	$1,786	$2,137	$2,453	$2,779
	Death	$1,700	$2,045	$2,320	$2,589
	Disability	$1,687	$2,017	$2,297	$2,550
1942 to 1946	Retirement	$1,818	$2,208	$2,552	$2,928
	Death	$1,723	$2,082	$2,358	$2,687
	Disability	$1,709	$2,063	$2,331	$2,642
1947 to 1951	Retirement	$1,853	$2,253	$2,622	$3,014
	Death	$1,745	$2,116	$2,405	$2,751
	Disability	$1,726	$2,089	$2,365	$2,703
1952 to 1957	Retirement	$1,887	$2,297	$2,695	$3,098
	Death	$1,772	$2,154	$2,465	$2,923
	Disability	$1,746	$2,119	$2,408	$2,757
1958 to 1963	Retirement	$1,916	$2,333	$2,750	$3,166
	Death	$1,808	$2,201	$2,545	$2,923
	Disability	$1,767	$2,146	$2,454	$2,812
1964	Retirement	$1,916	$2,333	$2,750	$3,166
	Death	$1,862	$2,267	$2,672	$3,077
	Disability	$1,772	$2,157	$2,471	$2,835

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Table A-9 AIME FOR WORKERS EARNING $41,000 TO MAXIMUM

APPROXIMATE BENEFITS FOR WORKERS EARNING $36,000 - $56,000 IN 1993					
YEAR BORN	AIME (Average Indexed Monthly Earning)	CURRENT ANNUAL INCOME			
		$41,000 to $45,000	$46,000 to $50,000	$51,000 to $56,000	$57,000 and Above
1931	Retirement	$2,699	$2,875	$3,064	$3,393
	Death	$2,587	$2,738	$2,901	$3,243
	Disability	$2,529	$2,669	$2,819	$3,164
1932 to 1936	Retirement	$2,859	$3,070	$3,299	$3,616
	Death	$2,676	$2,841	$3,020	$3,345
	Disability	$2,617	$2,769	$2,933	$3,263
1937 to 1941	Retirement	$3,082	$3,353	$3,647	$3,974
	Death	$2,828	$3,024	$3,236	$3,550
	Disability	$2,774	$2,955	$3,150	$3,456
1942 to 1946	Retirement	$3,291	$3,629	$4,001	$4,346
	Death	$2,980	$3,221	$3,481	$3,819
	Disability	$2,916	$3,139	$3,377	$3,712
1947 to 1951	Retirement	$3,391	$3,764	$4,192	$4,591
	Death	$3,068	$3,354	$3,690	$4,116
	Disability	$3,015	$3,279	$3,570	$3,950
1952 to 1957	Retirement	$3,492	$3,895	$4,340	$4,713
	Death	$3,137	$3,472	$3,859	$4,376
	Disability	$3,067	$3,366	$3,742	$4,211
1958 to 1963	Retirement	$3,583	$4,000	$4,458	$4,789
	Death	$3,270	$3,651	$4,069	$4,532
	Disability	$3,114	$3,459	$3,843	$4,375
1964	Retirement	$3,583	$4,000	$4,458	$4,800
	Death	$3,481	$3,886	$4,332	$4,712
	Disability	$3,147	$3,498	$3,896	$4,429

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Table A-10 RETIREMENT AND SURVIVOR BENEFITS

Match nearest AIME from Tables A-8 and A-9

RETIREMENT AND SURVIVOR BENEFITS					
AIME Average Indexed Mo. Earnings	**Retired Worker[1]**	**Retired Worker Age 62**	**Surviving Spouse (underage 60) & each child[2]**	**Surviving Spouse Age 60**	**Maximum Family Benefit**
4,800	1,363	1,090	1,022	974	2,384
4,700	1,348	1,078	1,011	963	2,358
4,600	1,333	1,066	999	953	2,332
4,500	1,318	1,054	988	942	2,305
4,400	1,303	1,042	977	931	2,279
4,300	1,288	1,030	966	920	2,253
4,200	1,273	1,018	954	910	2,227
4,100	1,258	1,006	943	899	2,200
4,000	1,243	994	932	888	2,174
3,900	1,228	982	921	878	2,148
3,800	1,213	970	909	867	2,122
3,700	1,198	958	898	856	2,095
3,600	1,183	946	887	845	2,069
3,500	1,168	934	876	835	2,043
3,400	1,153	922	864	824	2,017
3,300	1,138	910	853	813	1,990
3,200	1,123	898	842	802	1,964
3,100	1,108	886	831	792	1,938
3,000	1,093	874	819	781	1,912
2,900	1,078	862	808	770	1,885
2,800	1,063	850	797	760	1,859
2,700	1,048	838	786	749	1,833
2,600	1,033	826	774	738	1,807
2,500	1,018	814	763	727	1,780
2,400	1,000	800	750	714	2,400
2,300	968	774	726	692	1,693
2,200	936	748	702	669	1,649
2,100	904	723	678	646	1,606
2,000	872	697	654	623	1,563
1,900	840	672	630	600	1,520
1,800	808	646	606	577	1,478
1,700	776	620	582	554	1,435
1,600	744	595	558	531	1,392

[1] Normal retirement age for unreduced benefits

[2] Surviving spouse under age 60 must have at least one child under 16. Child's benefit continues to age 18

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Table A-11 DISABILITY BENEFITS

Match nearest AIME from Tables A-8 and A-9

DISABILITY BENEFITS

AIME Average Indexed Mo. Earnings	Disabled Worker	Disabled Worker Wife & Children	One Child No Surviving Spouse	Spouse Age 62
4,800	1,363	2,044	681	511
4,700	1,348	2,022	674	505
4,600	1,333	1,999	666	499
4,500	1,318	1,977	659	494
4,400	1,303	1,954	651	488
4,300	1,288	1,932	644	483
4,200	1,273	1,909	636	477
4,100	1,258	1,887	629	471
4,000	1,243	1,864	621	466
3,900	1,228	1,842	614	460
3,800	1,213	1,819	606	454
3,700	1,198	1,797	599	449
3,600	1,183	1,774	591	443
3,500	1,168	1,752	584	438
3,400	1,153	1,729	576	432
3,300	1,138	1,707	569	426
3,200	1,123	1,684	561	421
3,100	1,108	1,662	554	415
3,000	1,093	1,639	546	409
2,900	1,078	1,617	539	404
2,800	1,063	1,594	531	398
2,700	1,048	1,572	524	393
2,600	1,033	1,549	516	387
2,500	1,018	1,527	509	381
2,400	1,000	1,500	500	375
2,300	968	1,452	484	363
2,200	936	1,404	468	351
2,100	904	1,356	452	339
2,000	872	1,308	436	327
1,900	840	1,260	420	315
1,800	808	1,212	404	303
1,700	776	1,164	388	291
1,600	744	1,116	372	279

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ENDNOTES

Chapter 4

[1] Grace W. Weinstein, *Lifetime Book of Money Management* (New York: New American Library, 1987), p. 60.

Chapter 5

[2] Weinstein, pp 194-195.

Chapter 6

[3] "Compounding Inflation," *Forbes*, June 11, 1979, p. 108.

[4] James K. Gailbraith, *Balancing Acts* (New York: Basic Books, Inc., 1989), pp. 53-76.

[5] Postage stamp and gasoline prices taken from personal knowledge. Social security tax taken from 1992 tax tables. Median priced homes and mortgage rates, *The World Alamanac and Book of Facts 1993* (New York: Pharos Books, 1992), p. 714.

[6] John Case, *Understanding Inflation* (New York: William Morrow & Co., Inc., 1981), pp 99.

[7] Case, p. 103-104.

[8] Case, p. 105.

[9] Case, p. 111.

[10] *The World Almanac and Book of Facts, 1993*, p. 128.

[11] U.S. Bureau of Labor Statistics, *Monthly Labor Review and Handbook of Labor Statistics.*

[12] Galbraith, p. 62.

[13] Gerber, Wolff, Klores, & Brown, *Life-Trends* (New York: Avon, 1990), p. 3.

[14] *The World Almanac and Book of Facts*, p. 128.

[15] TMI Tax Service, *Quickfinder Handbook 1993*, (Minnetonka, MN), p. 18-3.

Chapter 9

[16] *ICA 1995 Investors Guide,* The American Funds Group (Los Angeles: Capital Research & Management Co.), p. 8.

[17] Lewis Carroll, *Through The Looking Glass* (Kingsport: Kingsport Press, Inc., 1979), p. 173.

Chapter 13

[18] *The World Almanac and Book of Facts 1995* (New Jersey: Funk & Wagnells, 1994), p. 968.

[19] Journal of the American Society of Chartered Life Underwriter. Commissioners Disability Tables.

Chapter 18

[18] Ross Perot, *Not For Sale At Any Price* (New York: Hyperion, 1993), p. 67.

GLOSSARY

ADJUSTABLE RATE MORTGAGE—A mortgage with a changing interest rate. The interest rate will rise or decline according to one of the national indexes.

ASSETS—Something you own that has value such as a home, stocks, or a savings account. An asset can also be something that is owed to you, like a note held for money to be paid in the future.

BABY BOOMERS—Those born during the twenty-five years following World War II. During this time, the birth rate greatly increased. As these people have aged, they have affected the economy in various ways due to their sheer numbers. When the baby boomers retire, there will be more retirees than workers.

BALANCE SHEET—A financial statement showing what you own and what you owe.

BALANCED FUNDS—A mutual fund that must keep a certain percentage of its assets in bonds or preferred stocks and the rest in common stocks. It is more conservative than a growth fund and tends to be more stable, not moving up or down very quickly.

BASIS—The amount of money a person has in an asset. This includes cash and loans. For example, the basis in a home would consist of the total purchase price, closing costs upon purchase, and all improvements made to the home. The basis for any investment is what you pay for it, plus other money spent to improve or add to the investment.

BENEFICIARY—Someone named to receive assets from another person upon their death.

BIG BOARDS—A popular term for the New York Stock Exchange and the American Stock Exchange since they are the two largest stock exchanges in the country.

BILATERAL—Having two sides. "Bi" is a Latin prefix meaning two.

BILL CONSOLIDATION LOAN—A larger loan by a second party to pay off many smaller loans.

BLUE CHIP STOCK—The stock from a well-known company. The company's products and services are widely used and the company has established its ability to make profits and pay dividends on their stock.

BODILY INJURY LIABILITY—A term used in auto insurance for liability protection. It provides financial compensation for injury or death caused by your automobile.

BOND FUNDS—A mutual fund that invests all or most of its money in bonds.

BONDS—An I.O.U. or promissory note of a corporation, government, or municipality. The issuing party promises to pay the bondholder a certain amount of interest for a specified time period for the "loan."

BREAK-EVEN RATE OF RETURN—What you must earn on your money to stay even with taxes and inflation.

BROKERAGE FIRM—A company that deals with taking orders from the public to buy and sell securities. The firm charges a commission for this service.

BROKERAGE ACCOUNT—Your personal account with a brokerage firm.

CASH FLOW STATEMENT—A financial statement that shows how much money a person or company brings in and how much they spend. It compares income to expenses.

CERTIFICATE OF DEPOSIT (CD)—A type of savings account issued by a financial institution. The institution promises to pay a set interest rate for a certain time period. At the end of the time period, the agreement ends.

CLOSED-END FUNDS—A mutual fund that offers a fixed number of shares. Once the specified number of shares are sold, new investors are allowed into the fund only by buying someone else's shares.

CLOSING COSTS—The many costs and fees associated with closing escrow on a home or other real estate purchase. These include recording fees, title insurance (to protect the lender), points or loan origination fees, title search, surveys and appraisals, preparation of documents, credit reports, attorney fees, and other costs.

CODICIL—An addition to a will to change or explain some of the will's provisions or to add new provisions.

COINSURANCE—A term often used with medical insurance. It is the amount the insured pays for each claim (often 20%) once they have met their deductible.

COLLISION INSURANCE—The part of automobile insurance that covers physical damage done to an automobile regardless of responsibility.

COMMERCIAL PAPER—A short-term note (from one to 270 days) issued by a corporation. The time period is fixed, but the interest rate fluctuates daily with the current market. The minimum investment is usually $25,000. Commercial paper is used by corporations to finance their short-term working capital.

COMMON STOCK—Securities representing part ownership in a company.

COMMUNITY PROPERTY—All property acquired during marriage, except gifts and inheritances, becomes community property. Each spouse owns 50% and is entitled to 50% when death or divorce occur. Current community property states are: AZ, CA, ID, LA, NV, NM, TX, WA, and WI.

COMPOUND INTEREST—Interest compounds when it is added to the principal on deposit with a financial institution. At the end of a certain time period (daily, monthly, quarterly, or annually), the interest is added to the principal, then the combined sum compounds to earn interest for the next time period. (See Rule of 72.)

COMPREHENSIVE—A type of automobile insurance that protects a person against physical damage done to their car. It covers a wide variety of perils not covered through collision or liability insurance. Some of these perils could be glass breakage, theft, fire, or flying objects.

CONSUMER PRICE INDEX (CPI)—Statistics gathered by the U.S. Department of Labor, Bureau of Labor Statistics to show the change over time of prices in goods and services. It measures what a sample of goods and services cost today compared to some time in the past. Since the CPI is an index of the rising cost of goods and services, it measures inflation.

CREDIT REPORT—A report issued by one of the many credit bureaus showing a person's payment history on credit cards and other installment debt. These reports are used by lending institutions to determine if the person has been diligent in meeting their obligations.

DEDUCTIBLE—An insurance term used in automobile, homeowner's, and medical policies stating the amount the insured agrees to pay before their policy starts paying. Medical policies have a deductible that is met each year; the other policies have a deductible that is paid for each claim filed. For all policies, the higher the deductible, the lower the cost of insurance.

DISABILITY INCOME PROTECTION—Insurance that protects the insured against lost wages should they become either permanently or totally disabled and unable to work.

DIVERSIFICATION—Spreading investment dollars among many different investments or many different companies. Diversification is automatic with mutual funds since ownership in one fund represents ownership in hundreds of companies.

DIVIDENDS—Payments to stockholders from the issuing corporation. Dividends come from the company's current profits, or sometimes past earnings. Stockholders are paid equally for each share of stock owned, although amounts vary for common and preferred stock.

DOLLAR COST AVERAGING—A system of buying stocks or mutual funds at regular intervals to balance the highs and lows associated with market fluctuations.

EMERGENCY FUND SAVINGS—A term used in financial planning for a savings account designated to cover unforeseen family emergencies.

ENROLLMENT PERIOD—A term used in group insurance contracts that are offered by employers. During the enrollment period, all members of the group are admitted for an amount of health or life insurance (determined by the employer) regardless of insurability or prior health conditions.

EQUITY—The value of property beyond the total amount owed on it. This equity is an asset.

ESTATE PLANNING—The process of planning for the disposition of assets accumulated during a person's lifetime. A good estate plan will minimize taxes and provide for the passing of assets to heirs in a timely manner.

ESTATE TAX—A federal tax levied upon property transferred at death. Currently a taxpayer has a $600,000 exemption, so no taxes are due on estates worth less than the exemption amount.

EXCHANGE PRIVILEGES—A term used by mutual fund companies that allows money to be transferred from one or more funds within their family to other funds within their family.

FEDERAL DEPOSIT INSURANCE CORPORATION (FDIC)—Insurance offered by the federal government to cover deposits in member banks and credit unions. Each account is covered for a maximum of $100,000.

FEDERAL RESERVE—Responsible for the monetary policy of the country. Their concerns are full employment, steady growth, and stable prices. The Federal Reserve Board controls the amount of money in circulation. When more money is in circulation, prices and interest rates begin to rise.

FEDERAL DEFICIT—When the government spends more than it takes in, the result is a deficit. Each year the government has deficit spending that amount is added to the public debt. The cost of the public debt is shared by all taxpayers.

FINAL EXPENSES—A life insurance term used to pay burial and funeral expenses.

FIXED EXPENSES—An expense that is the same amount each month. This term is used in budgets and financial statements.

FIXED INCOME—Income that is the same each month. It can come from interest earnings on a savings account, from a fixed pension, or from bonds, mortgages, and notes.

FIXED INTEREST MORTGAGE—A mortgage having the same payments and same interest rate for the term of the mortgage, normally 15 or 30 years.

FIXING-UP EXPENSES—Used in figuring the profit from the sale of a principal residence. Fixing-up expenses are made to make the home more salable and are incurred 90 days prior to signing the contract

GENERAL PARTNER—The managing agent of a limited partnership who generally purchases the investment and assumes responsibility for prudent, daily management.

GIFTING—A term used in estate planning. It is a method of giving assets to heirs early, thereby removing them from the donor's taxable estate. Currently each person is allowed to gift up to $10,000 each year with no gift tax due. The beneficiary only pays taxes on the earnings from the gift. The gift itself has no taxes due.

GLOBAL FUNDS—Mutual funds that invest in stocks and bonds worldwide.

GOVERNMENT SECURITIES—Treasury Notes, Treasury Bills, and Treasury Bonds issued by the federal government. The earnings from these securities are exempt from state income taxes.

GRACE PERIOD—Most state laws require that life insurance carry a 30 day grace period to make a past due premium payment before the company cancels the policy. Automobile insurance and homeowner's insurance are not required to have grace periods. When premiums are not received on time, the company automatically cancels the policy.

GROUP LIFE INSURANCE—An insurance plan offered by an employer for the employees. Group plans allow life insurance coverage to decrease with age so the employer can pay the same premium for all employees. Therefore older employees have less insurance coverage than younger employees.

GROWTH STOCK—Stock issued by an emerging company that has shown a rapid increase in earnings.

GROWTH FUNDS—Mutual funds that invest primarily in growth stock.

GROWTH AND INCOME FUNDS—Mutual funds that have a dual purpose: growth and income.

HARD ASSETS—Investments in gold, silver, and other precious metals.

HEALTH MAINTENANCE ORGANIZATIONS—A new concept for providing total health care under one roof. FHP and Kaiser Permanente are two examples. Doctors and other health care employees work set hours. Lab work, X-rays, and other diagnostic work is performed in the same complex as the examining physician.

HEALTH INSURANCE—Insurance to cover illness and accidents. Policies are sold with an annual deductible, usually $100 - $250. After the deductible is met, the insurance will pay a percentage of all covered medical costs, the standard is 80% (see Coinsurance). After reaching the stop loss clause, the policy pays 100% of all charges up to the policy limits.

HOME EQUITY LOAN—Lending institutions usually offer these loans to those who have more than 20% equity in their home. They will take a second trust deed on the property to secure the loan. Some institutions will offer a loan up to 90% of the appraised value of the home.

HOME EQUITY LINE-OF-CREDIT—Similar to a home equity loan, except instead of receiving cash for the equity, the owner receives a line of credit with the institution. The owner can then write checks up to the amount of the credit. Once the balance is paid down, or paid off, the credit can be reused.

INCOME MUTUAL FUNDS—Mutual funds that have the goal of providing a steady dividend. They will usually invest in government securities, corporate bonds, or certificates of deposit.

INFLATION—A rise in the cost of goods and services as measured by the Consumer Price Index.

INFLATION HEDGE—An investment that will increase in value over the years and stay ahead of the combined increases paid for goods and services.

INSTALLMENT DEBT—Credit cards and bank loans that are paid off in monthly installments.

INSURANCE COMMISSIONER—A state official who regulates the insurance industry within that state. The commissioner enforces the state insurance code, making certain that companies and agents comply with the code.

INSURED—The party that owns insurance as a form of protection against unknown losses.

INSURER—The insurance company which provides a certain type of insurance for a set premium.

INVESTMENT COMPANIES—The name given to companies that offer and manage mutual funds.

JOINT TENANCY WITH RIGHT OF SURVIVORSHIP—An asset owned by two parties that passes to the surviving party or parties when one dies.

JUNK BONDS—Low-grade bonds with a substandard rating. They carry more risk and pay higher interest than higher rated bonds.

LIABILITIES—Claims against a corporation or an individual. They include money owed for taxes, wages, bank loans, and other debts.

LEVERAGE—Using borrowed money to make money.

LIABILITY INSURANCE—In a homeowner's policy, liability covers medical payments to others if they are injured on the insured's property. It also covers physical damage to the property of others that occurs on the insured's premises.

LIFE INSURANCE—Insurance to cover the loss of life of the primary wage earner(s) of a family. Available policies fall within two categories: whole life (a savings portion is attached), or term (pure insurance). Both concepts come in many varieties.

LIMITED PARTNERSHIPS—An investment vehicle managed by a general partner for the benefit of a specified number of limited partners. The limited partners put up the money and participate in their pro rata share of income distributions from the partnership. The general partner assumes responsibility for management.

LIMITED PARTNER—An investor in a limited partnership.

LIQUID ASSETS—Assets such as bank account savings that can be readily converted to cash.

LIVING TRUST—A legal document drafted for the benefit of a person who often names themselves as the beneficiary. It can also pass property to heirs upon the maker's death, avoiding the cost and time of probate.

LOAN ORIGINATION FEE—A charge by a financial institution for a new mortgage loan. In reality it is the commission paid to the institution and/or the loan officer. It is commonly referred to as "points."

MEDICAID—A health insurance program for people with low income and limited assets. It is usually run by state welfare or social service agencies.

MEDICARE—A federal insurance program for people age 65 and older and other people with qualifying disabilities.

MEDIGAP—Private insurance policies designed to cover the portion of medical expenses not covered by Medicare.

MONEY MARKET FUNDS—A mutual fund that invests in short-term money investments such as certificates of deposit and corporate commercial paper. Some funds invest solely in government obligations. The interest rate changes daily, and compounds daily.

MOODY'S INVESTOR SERVICES—A service that rates bonds according to their volatility. From highest to lowest, bonds are rated: Aaa, Aa, A-1, A, Baa-1, Baa, BA, B, Caa. The highest rated bonds are considered prime, while the lowest are considered speculative.

MORTALITY TABLES—A base for calculating the cost per thousand for a life insurance policy. The mortality tables show how many people died during a certain time at each age.

MORTGAGE INSURANCE—Decreasing term insurance often sold to cover a mortgage. The insurance declines each year as the mortgage decreases.

MUTUAL FUNDS—Investments in stocks, bonds, and cash accounts that are diversified over thousands of different investments to meet a stated objective of the fund such as growth, growth and income, or income (many variations exist within each of these objectives). All funds will have an objective, and the fund manager selects the investments to meet that objective. New shares are continuously offered to the public and current shares can be redeemed on demand.

NASDAQ—An acronym for National Association of Securities Dealers Automated Quotations, an information network that provides brokers and dealers with price quotations for trading on the over-the-counter market.

NATIONAL ASSOCIATION OF SECURITIES DEALERS (NASD)—A branch of the Securities and Exchange Commission that oversees the selling of securities by brokers and dealers. The NASD is committed to enforcing their rules of fair practice, to preventing fraudulent acts, and to seeing that investors receive full disclosure via a prospectus or offering circular. All persons selling securities to the public must be licensed and registered with the NASD.

NET WORTH—On a net worth statement, net worth equals assets minus liabilities. It shows what a person or company owns free and clear after all debts are paid.

NET WORTH STATEMENT—A financial statement that lists the assets and liabilities of a person or a business. The bottom line is the net worth: what is left after all debts are paid.

NET ASSET VALUE (NAV)—A term used by mutual fund companies to show what each share of the fund is worth. NAV is calculated daily by subtracting the fund's liabilities from the market value of the shares, and dividing the balance by the number of shares outstanding.

NET SALES PRICE—A tax term used for the sale of real estate and other assets. The net sales price is the contract sales price minus the selling costs.

NO LOAD FUNDS— Mutual funds that are sold through fund advertising rather than through broker-dealers and registered representatives. The investor pays no sales charge.

NONFORFEITURE OPTIONS—A life insurance term. If the owner stops making payments on a permanent policy, the life insurance company must give to the owner the cash value of the policy, or insurance benefits equivalent to the cash value. The cash value and the equivalent benefits are referred to as nonforfeiture options.

ONCE-IN-A-LIFETIME EXCLUSION—A tax term referring to excluding $125,000 of capital gains for taxpayers age 55 and older on the sale of a principal residence. They must live in the home three out of the five years preceding the sale. The exclusion can only be taken once by either husband or wife. Death or divorce does not reopen the option.

OPEN-END FUNDS—Mutual funds that continuously offer new shares to the public and will redeem current shares upon request of the shareholder.

OVER-THE-COUNTER MARKET—Securities traded by securities dealers for their clients. The securities sold are from smaller companies that do not qualify to have their stock listed on one of the exchanges.

PERSONAL PROPERTY INSURANCE—Insurance used to cover personal belongings such as appliances, furniture, and jewelry. Homeowner's policies usually automatically cover personal property for one-half of the dwelling coverage. Renters must buy a separate renter's policy to cover their belongings.

POINTS—A type of prepaid interest on a mortgage loan (loan discount), or a loan origination fee, which is a service fee paid to the lender.

POLICY LIMITS—The limit or cap that an insurer will pay per individual for major medical insurance.

PREFERRED STOCK—A class of stock that has a claim on the company's stock before common stockholders are paid. If the company liquidates, preferred stockholders have priority over common stockholders.

PREMIUM—1) When the market price for bonds and preferred stock rise above the original purchase price, they sell for more than their par value, and are said to be selling for a premium; 2) Dollars paid in exchange for insurance coverage. Insurance can protect a person's income or value of work performed, a home, personal belongings, automobiles, illness, accidents, and disability.

PRIVATE MORTGAGE INSURANCE—An insurance policy written to protect the lender of a mortgage from declining prices when they have more than 80% invested in the property.

PRIVATE PLACEMENT—A type of limited partnership that raises smaller amounts of money and is not required to be registered with the SEC. There can be no more than 35 limited partners.

PROBATE—The legal process of passing ownership of property from a deceased person to others. If there is no will, probate will pass the property to heirs according to state law.

PROSPECTUS—A document required by the Securities Act of 1933 that discloses pertinent information about an investment. Registered representatives are required to give a prospective investor a prospectus before accepting money and filling out an application.

REDUCED PAID-UP INSURANCE—A nonforfeiture option for permanent life insurance policies. The cash value purchases a reduced, paid-up policy.

REFINANCING—Refinancing occurs when a mortgage holder takes out a new loan on their home or other real property. People usually refinance when interest rates drop 2% or more below their original mortgage, or when property values rise, giving them more equity in their home.

REGISTERED REPRESENTATIVES—A reference to men and women who sell securities. They are required to be registered with the NASD (National Association of Securities Dealers), the branch of the Securities and Exchange Commission that regulates brokers and their representatives.

REITS—Real Estate Investment Trusts. A type of mutual fund that owns real estate investments instead of stocks and bonds. REITS are traded on the stock exchanges.

RENTER'S INSURANCE—An insurance policy offered to renters to protect their personal belongings against theft and destruction from certain perils.

RIDER—An addendum to an insurance policy that gives additional coverage for an additional premium.

RULE OF 72—A rule used to easily calculate how many years it will take for a given sum to double at a specified interest rate. Dividing the interest rate into 72 tells how many years it will take for the principal to double. $1,000 earning 6% will double in 12 years (72 divided by 6 = 12)

SABOTEUR—One who causes loss, damage, or destruction.

SECOND TRUST DEED—A mortgage on a piece of real estate that is in second position to the first lien holder.

SECURITIES—Investments such as stocks, bonds, mutual funds, and limited partnerships that have no guarantee for their performance. They must be purchased through a securities dealer that is registered with the Securities and Exchange Commission.

SECURITIES AND EXCHANGE COMMISSION (SEC)—The Securities and Exchange Commission was established by Congress to help protect investors.

SECURITIES INVESTOR PROTECTION ACT (SIPC)—Congress passed the Securities Investor Protection Act in 1970 to protect investors from loss if a brokerage firm fails. Each member firm pays an amount to the SIPC fund. If a member firm fails, the SIPC fund covers the liabilities owed by the broker.

SELF-INSURANCE—An amount you determine that you can afford to pay for a certain loss. If you self-insure, you reduce the premiums you will pay to an insurance company.

SERIES EE BONDS—A U.S. Government bond sold in denominations ranging from $25 to $5,000. The interest earned can be tax free if used for education.

SETTLEMENT STATEMENT—A final statement given to persons who have purchased a personal residence or other real estate. It lists the price paid for the property and all amounts dispersed from the escrow account to pay for expenses.

SIMPLE INTEREST—Interest that is not added to the principal at the end of the compounding period.

SPECIALTY FUNDS—A mutual fund that invests in a particular product or has a special emphasis. Some examples are gold funds, environmental funds, health care funds, and overseas funds.

STANDARD RISKS—A person considered to be an average insurance risk according to their age and current health condition, or their current driving record.

STANDARD AND POORS—A company that rates bonds. From highest or prime grade to lowest or very speculative bonds, their ratings are: AAA, AA, A, BBB, BB, B, CCC.

STATE INSURANCE CODE—The law that regulates insurance companies within that state. It is enforced by the insurance commissioner.

STEPPED-UP BASIS—When an investment passes to an heir at its market value as of the date of death, rather than the original purchase price, it is said to have a stepped-up basis.

STOCKS—Ownership of shares in a corporation.

STOP LOSS CLAUSE—A feature of major medical insurance that relieves the insured from paying any more once a certain limit is reached, such as $5,000 or $10,000.

SUBSTANDARD RISKS—A person considered to be an above average risk for health, life, or automobile insurance.

TAKING TITLE—The many ways that real estate or other property can be owned by one or more persons. Some examples are: 1) joint ownership with right of survivorship, 2) tenants in common, 3) tenants in the entirety, 4) separate property, and 5) community property.

TAX BRACKET—The percentage paid in federal and state income taxes once income reaches a certain level.

TAX SHELTERED ANNUITY—A contract with an insurance company, usually under section 403(b) of the I.R.S. code, where the participant pays in a monthly sum that comes from payroll deduction. The contribution is tax deferred until withdrawal. The amount paid reduces gross wages dollar for dollar.

TENANTS IN COMMON—A way to hold title on property among any number of persons. It can also denote unequal ownership. Each co-owner has a separate legal title to his/her undivided interest. Co-owners can sell their share of the property without permission from the other tenants. Upon a co-owners death, the property passes to his/her heirs according to his/her will. No right of survivorship exists among tenants.

TENANTS BY THE ENTIRETY—A way to hold title on property among any number of persons that can also denote unequal ownership. Each co-owner has a separate legal title to his/her undivided interest. Upon a co-owners death, the property passes to the other tenants. Co-owners cannot sell their portion of the property without the permission of others.

TERM RIDER—An addition made to a life insurance policy that provides for additional term coverage for additional premiums paid.

TERM INSURANCE—A reference to life insurance contracts that have no cash value build-up. The insurance premiums pay for the cost of pure insurance and will not be returned to the insured.

TESTAMENTARY TRUST—Created as part of a will. It can be canceled or changed before the will maker dies. It comes into existence upon the death of the will maker.

GLOSSARY

TITLE INSURANCE—Required by lenders to protect their ownership in the property. The insurance will pay the lender if title to the property is contested by the courts and the lender loses their investment.

TITLE SEARCH—Research done by an escrow company to make sure the ownership of the property is as stated.

TREASURY BONDS—Bonds with holding periods of 10 years or longer that are offered by the U.S. Government. The interest earned is not taxable to the states.

TREASURY NOTES—Short-term investments ranging from 2 to 10 years that are offered by the U.S. Government. Interest earned is not taxable to the states.

TREASURY BILLS—Short-term debt securities offered by the U.S. Government. Minimum investment starts at $10,000. The holding period can be 3 months, 6 months, or one year. The interest earned is exempt from state income taxes. New issues are sold through a Federal Reserve Bank; outstanding issues are traded on the over-the-counter market.

TRUST DEED—On pieces of real property, a trust deed is taken by the lender to secure their interest in the property. Should the mortgagee not make the payments as promised, the lender can repossess the property.

TRUSTS—Used in estate planning to minimize estate taxes, avoid probate and pass assets on to heirs in the most efficient manner.

UMBRELLA POLICY—An umbrella liability policy can be an insurance rider to a homeowner's policy that gives liability protection for incidents such as lawsuits or unusual accidents that are not covered by other insurance.

U.S. GOVERNMENT SECURITIES—Used to refer to U.S. Treasury Bonds, U.S. Treasury Bills, and U.S. Treasury Notes.

UNDERWRITING—A procedure used by life insurance companies to approve a party for insurance. Underwriting determines if the company will insure the amount applied for. They may order medical records from doctors and hospitals and require urine or blood specimens.

VARIABLE EXPENSES—Used in budgeting or in preparing financial statements. For individuals, they are expenses that vary month to month. They are usually expenditures for items like food, clothing, and recreation.

WILLS—A will determines how property will be distributed to heirs upon the maker's death. Wills also name guardians for minor children and appoint executors for the estate.

ZERO COUPON BONDS—These bonds are sold at a discount and are worth their face value at maturity. Although interest is not paid annually, it is taxable annually.

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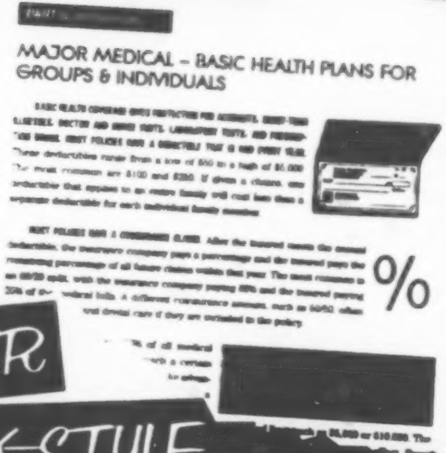
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